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POSTAVENIE ETIKY NA MEDZINÁRODNÝCH FINANČNÝCH TRHOCH

THE STATUS OF ETHICS IN THE INTERNATIONAL FINANCIAL MARKETS

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V súčasnosti sú medzinárodné finančné trhy kritizované najmä pre nedostatok, respektíve absenciu etiky v aktivitách na finančných trhoch, výskyt morálneho hazardu, vysoký podiel špekulatívnych obchodov a neudržateľnú hru s rizikom. V predkladanom príspevku sa venujeme analýze predpokladu významnej úlohy etického správania sa subjektov na medzinárodných finančných trhoch a charakteristike významných faktorov, ktoré prispievajú k zvýšenému sklonu k neetickému správaniu na trhoch. Cieľom skúmania danej problematiky je identifikácia niektorých eticky otáznych foriem správania na finančných trhoch, ktoré ponúkame k ďalšej diskusii.
Kľúčové slová: etika, finančné trhy, špekulácie

Nowadays, international financial markets are particularly criticized for a shortage, or absence, of ethics in their activities, creating a presence of moral hazards, as well as a high proportion of speculative trading and therefore competing in an unsustainable game of risk. This article offers an analysis of the significance of ethical behavior in international financial markets. We also examine notable factors that contribute to the increased tendency for unethical behavior in financial markets. The purpose of this research is to identify ethically questionable forms of behavior in financial markets and to discuss them.
Key words: ethics, financial markets, speculation
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1 INTRODUCTION

One of the first references related to ethics in the field of economics is found in Aristotle's *The Nicomachean Ethics.*[2] Aristotle (2010, p. 67) stated that "regarding things that have a use, it is possible to use them either well or badly and wealth belongs among things useful to us." Aristotle did not consider wealth as something negative or useless, but on the contrary he regarded wealth as beneficial – if it is used correctly. If good or correct usage is equivalent or comparable to ethical behavior, we can state by analogue that financial markets are beneficial to those subjects who interact and use them correctly.

Amartya Sen (1987), in his book *On Ethics and Economics,* attempts to explain the symbioses between ethics and economics, the combination of which can potentialy lead to more productive economies. He remarked with regard to the historical evolution of modern economics, that economics and politics were both branches of moral ethics. From the outset, economics has shown a tight coherance with ethics and moral philosophy. As testament to this, economics was formerly taught at Cambridge university as a part of Moral Science, which also referred to the original nature of economics. For instance, Adam Smith, who was later to became the "father" of modern economics, was originally a professor of moral philosophy.

However, Sen also mentioned that some authors (for instance Lionel Robbins in his work *An Essay on the Nature and Significance of Economic Science*) questioned the logic of associating these two disciplines together, seeing them almost as mutual opposites. In Sen's words "he [Robbins] was taking a position that was quite unfashionable then, though extremely fashionable now". We can subsequently add that an effort to separate ethics from economics is today not only fashionable, but for some groups also very advantageous. These groups are able to achieve an enormous profit to satisfy their needs, and on the other hand their behavior contributes to the collapse of whole financial systems.

In this paper we will discuss some of the questionable forms of behavior within financial markets, which do not follow principles of ethics and may also cause turmoil on financial markets. The main **purpose** of this paper is to define the status of ethics in international financial markets, to discuss the need of ethics in financial markets, to identify the main supporters of unethical practices in those markets and to give examples of problematic areas where ethics in financial markets has already collapsed. Using **methods** of analysis and synthesis we will identify ethically questionable forms of behavior in financial markets. The main **contribution** of the present paper consists in methodological summarization of the status of ethics in financial markets which we develop into crucial questions for further research in this field.

[2] If we consider wealth as a part of economics during that period.

2 DEFINITION OF ETHICS IN THE ECONOMICS

The first section provides a brief summary of general definitions of ethics by different authors. The section refers to different authors who offer various definitions of ethics, not only from the economist's point of view.

According to the *Oxford English Dictionary*, we can define ethics in general as "moral principles that govern a person's behavior or the conducting of an activity". The *English Collins Dictionary* lists a range of items that are covered by the word, such as "conscience, moral code, morality, moral philosophy, moral values, principles, rules of conduct, standards". The term ethics is also used to describe the norms or standard that the community applies to evaluate an individual's behavior (Clements, 2010, p. 6). In general, if we apply the definition of ethics to general perception of world economy, we are able to identify a few common principles that mankind as a "world community" applies to evaluate the behavior of individuals.

Philip J. Clements (2010, p. 2) considered the universal business standards in the following sentences: "We will not break the law", "The customer is always right", and the the Golden rule "Do unto others as you would have them to do unto you", as well as "do what is right all of the time." The former statements concerning ethical behavior are also valid in cases where we neglect the diversity of cultural, religious, social, economic and other characteristics of different states, nations and countries in the world. Although the statements are generally applicable, separately they are not sufficient for a perfect description of an ideal relation between ethics and economics, or between ethics and the behavior of economic subjects. Clements (2010, p. 2) claims that the statement about not breaking the law is a minimum standard and not adequate for business. Furthermore he indicated that the "do what is right all the time" statement reinforces the importance of high standards and that the business motto "the customer is always right" only prioritizes the customer over company interests; nevertheless customer interests often break the standards.

John Maxwell, in his work *There's No Such Thing as Business Ethics*, summarized all business principles into the Golden rule. The Golden rule seems to express the basis of ethical behavior or ethics as a whole. It does not deny the concept of homo economicus, which considers humans as rational and self-interested actors able to make their own decisions. Adam Smith (1998, p. 30) wrote in his well-known work *The Wealth of Nations* that "it is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own interest", thus he presented a human being as an egoistic actor who only focuses on satisfying his own needs and interests. However, to behave ethically according to the Golden rule is in the interest of every "homo economicus", because "do unto others as you would have them do to you" or in negative form "one should not treat others in ways that one would not like to be treated" brings everybody an advantage or some kind of a benefit. We could also describe ethics according to Dempsey (1999)"as a long-term consideration and an effort to resolve the conflict between selfishness and selflessness; between our material needs and our conscience“.

3 THE IMPORTANCE AND NEED OF ETHICS IN THE FINANCIAL MARKETS

The third section of this paper introduces general characterization of financial markets, financial markets' subjects and certain forms of unethical behavior which existence on financial market attack its vulnerability. Moreover, the section discovers the reason of the need of ethics on financial markets.

Generally, each market is defined as a mechanism for implementing the interests of market actors, as a place for an interaction between buyers and sellers. Specifically, a financial market can be defined as a place where supply and demand for financial resources encounter each other and where the owners of available financial resources meet the candidates interested in their use. The financial market is also a place where various financial instruments are traded or exchanged. International financial markets, which connect various national financial markets, can be classified in various ways. The basic classification is divided into three branches – international monetary market, international capital market and international derivatives market.

Among the major players in the international financial markets are: individuals as owners of financial resources with an interest to valorize them effectively; companies interested in advantageous acquirement of capital resources; governments with the need to finance their debts; investment banks seeking opportunities for capital appreciation and commercial banks as mediators for households to access the financial markets; mutual, pension, sovereign and hedge funds as tools for various types of investments; central banks which control the market situation. An outstanding role is played by intermediaries, who simplify the operation and location of free capital movement and who provide direct access to the financial market.

Ethics in financial markets or the financial sector covers all financial activities like banking ethics, stock market ethics, insurance ethics, and ethics of gambling, debt management, microfinance, speculation, black markets, money laundering and others (Stückelberger, 2012, p. 43). The vulnerability of financial markets is mainly affected by unfair trading practices as fraud trading, manipulations with prices and conditions, uncontrollable games of risk, speculative operations, greed of market subjects, contractual difficulties and many others.

Unfair trading practices help decrease investor confidence in the integrity of financial markets and speculative activities produce excess volatility of market prices (Jamnik, 2011, p. 154). The main aim of laws and the self-regulation of exchanges is expressed in the phrase "fair and orderly" markets, which reflects the need in financial markets to balance the twin goals of fairness and efficiency (Jamnik, 2011, p. 154). There is a tendency to make fairness and ethics synonyms. People sometimes say they have been treated unfairly or unethically, by which they usually mean they believe one of their rights has been violated (Shefrin – Statman, 1993, p. 23). In this article we will consider fairness on financial markets as one of the essential ethical requirements. Fairness can possibly be defined either substantively (meaning that the price of a commodity or security reflects the actual value) or procedurally (when buyers are able to determine actual value of a commodity or security) (Jamnik, 2011, p. 157). Fairness is closely linked to the fact that nowadays not every market participant has the same access to information. Information asymmetry in international financial markets is an important current market feature. At present, information in financial markets could be defined as highly expensive, distorted, and inadequate and each participant evaluates them otherwise. Possession of different information is a pervasive feature of markets that is not always ethically objectionable (Jamnik, 2011, p. 154).

One of the main motivating factors for market subjects to participate in financial market is a mediation of available financial resources from subjects who have an excess of financial resources (a creditor) to another subjects who need it (a debtor). The main reason for a creditor to provide available financial resources to financial markets is an effort to capitalize and benefit from international diversification or price differences. On the other hand, the main reason for a debtor to obtain financial resources from financial markets is to borrow at as low an interest rate as possible. The relation between creditor and debtor has to be inevitably built on trust and control. Every economic system or market needs trust at all levels as a basic condition of economic transactions. Credo (the belief, the convictions, the ethical values of a person, group or institution) leads to credibility, which in turn leads to credit, therefore the simple formula for trust and ethics in finance is: Credo + Credibility = Credit (Stückelberger, 2012, p. 43). According OECD (2003, p. 2) "the ability of financial intermediaries to make credible commitments to a certain number of rules and standards of behavior is the source of investors' trust and confidence – ethics makes trust possible." Fairness and trust or credo are important features of current markets, without them we observe a tendency of a violation of ethics in behavior of market participants.

4 SUPPORTERS OF THE UNETHICAL PRACTICES ON INTERNATIONAL MARKETS

We assumed that the existence of unethical behavior has to be driven by "supporters" who enable the presence of unethical practices on international financial markets. In the following paragraphs we seek to identify and describe three main drivers of unethical behavior of market subjects which are closely linked. At present, the functioning of international financial markets is criticized for a high share of speculative financial transactions and the unsustainable risk game, which according to common opinion, does not fit into the framework of ethical behavior, or at least is located on the boundaries between ethical and unethical behavior. We will discuss the issue of speculation as a main supporter for unethical practices in financial markets, also the existence of economic bubbles as a popular phenomenon specific to financial markets that provide a suitable environment for unethical behavior. We will also discuss financial derivative instruments as tools for this kind of practice. It is possible to identify close relations between speculation, economic bubbles, and financial derivatives. We suppose that questionable ethical issues have their roots in speculative behavior, and that they appear mostly within economic bubbles and are practiced by derivative instruments.

4.1 SPECULATION AS A MAIN SUPPORTER FOR UNETHICAL BEHAVIOR

A debate related to the perception of speculation on markets has appeared within the academic community since the end of 18th century. The question examines whether the speculation itself is ethically permissible and whether it is possible to justify using speculation on the market or otherwise. Primarily, the dilemma was based on closer specification of speculation as gambling or as a kind of betting. While betting was considered ethically acceptable because it contained a stronger element of intelligent forecasting of reality, conversely, pure gambling was described as relying only on a random sequence of circumstances (Homann – Koslowski – Luetge, 2007, p.222). The debate was concluded with the statement that speculation is not only a pure gambling, because it also incorporates expectations of future development of the market and its subjects. However, these expectations are based on incomplete information and insufficient quantities of empirical data. For centuries, this speculation was characterized in many ways as an activity to anticipate the behavior of market participants and thus to predict the market behavior (Keynes, 2002), as a stimulus for the economy and the existence of financial transactions (Brockway, 1983), as a means of strengthening the mechanism of Friedman's "the invisible hand of the market" or even as a benefit for society if it fills its economic function (Katsuhito, 2010). This means that if speculation means moving goods from the time of their surplus to the period of scarcity, it follows that it must help improve market efficiency (Samuelson, 2010).

An essential element and a motive of using speculative financial operations is the basic principle of speculative operations – leverage. Financial leverage works on the principle of using a small amount of equity by larger volumes of foreign capital to finance investments. The most common example of using leverage is financing through some form of financial derivative (in the next section we will discuss its role during a crisis). This means that we can dispose of a large volume that we do not have, using only a relatively small amount of equity we really possess. One of the main differences of trading by speculative financial transactions compared with the real trade is change of the nature of a business subject. The speculative operations change trading assets (specific property owned) to trading liabilities (foreign capital). Basically, we do business with something that we do not actually own. The huge amount of foreign capital that can be handled simplifies to recourse to activities connected to risky behavior. The ethical question is based on the extent to which speculative behavior with a high degree of risk is compatible with ethical considerations.

A degree of leverage that causes the illusion of increasing the perceived value of the underlying asset was added to derivative financial instruments, which can be regarded as a materialization of speculative financial operations. We can increase the illusion of increased value of underlying assets by gradual layering of risk, thus by increasing leverage. Speculative trading is becoming more attractive because it offers the possibility of higher profits and at the same time it is more dangerous because it equivalently increases the risk of loss. The leverage principle has been opened to a wide range of economically inexperienced subjects, especially individuals and households, which are prone to make irrational decisions with the only aim to make a profit.

4.2 ECONOMIC BUBBLE AS AN ENVIRONMENT FOR UNETHICAL BEHAVIOR

The next significant trend on international financial markets is the economic bubbles boom. Economic bubble is a term usually used for the type of economic cycle, which is characterized by sudden expansion, followed by a decrease, many times more dramatic than the initial expansion was. The economic bubble concept also assumes that prices will always rise above their real value, and the increase will continue until prices fall and the bubble bursts.

Minsky's hypothesis in the environment of economic bubbles distinguishes three different concepts of company funding: hedge finance, speculative finance and Ponzi finance (Kindleberger, 2011, p. 29). While hedge finance is sufficient to cover interest payments plus regular indebtedness reduction, in speculative finance new loans must provide for the funding for these purposes. Nowadays, the term Ponzi finance is a general expression for unsustainable forms of funding. In case that hedge finance prevails in the economy, it has an increased tendency for equilibrium searching; if the speculative or the Ponzi finance concept dominates, we recognize the economy as a system with strong deviations (Sivák – Ochotnícky, 2009, p. 4). Minsky argues that in an economy where bubbles had occurred, after boom phase when economic growth had been slowed, companies' funding began to change. Companies that have previously funded their costs by hedge finance tend to move towards speculative finance concepts and companies that have used speculative finance concepts of funding began to enter into the Ponzi finance model. According to the Minsky hypothesis we assumed a tendency, which significantly increases the negative effects of the bubble burst in the economy. We follow the fact that a certain group of companies, which at the time of the euphoria phase of the bubble had funded their costs by risky finance methods, began to ensure liquidity with even riskier and more dangerous ways of funding in the panic phase.

4.3 FINANCIAL DERIVATIVE AS A TOOL FOR UNETHICAL PRACTICES

Derivatives as financial tools cause the future risk to become negotiable. One of the main reasons of trading is to eliminate uncertainty through market risks exchange known as hedging. Derivatives serve as an insurance against unwanted and unexpected price fluctuations and they reduce cash flow volatility of the company. Another reason for using derivatives is their perception as an investment. Derivatives trading can be an alternative way of direct investment in assets without a real asset possession. Derivatives also allow investing in the assets that it is not possible to buy directly (for example special types of exotics, which are tied to weather forecasts and offer compensation if the temperature in a given area exceeds or falls below a predefined reference temperature). The main advantage of derivatives trading is risk protection with minimal investment and low total transaction costs in comparison with the investment needed to buy an underlying. Derivatives allow rapid product innovation because new contracts can be swiftly introduced to the market. A major advantage, and at the same time a danger, is that nowadays derivatives are ready to fully customize the terms of trade to specific user needs. Current derivative financial instruments are complex, demanding, more and more flexible, and constantly evolving.

The global economic and financial crisis was an evidence that the presence and implementation of high-risk financial instruments destabilize financial sector. High-risk financial instruments, also called toxic assets are the result of uncontrolled speculative games of risk. The speculative operations are the main engine of creation of dangerous and risky derivative instruments. According to the OECD report, the global financial crisis was caused by a combination of risk underestimation and innovative changes of such derivative instruments that allowed leverage to increase uncontrollably (Wignall – Atkinson, 2011). Derivative trading is a game of risk. No policy and no model can eliminate it (Chorafas, 2008, 227). Risk is defined as the probability or threat of harm, injury, a burden, loss or other negative events, which is caused by external or internal vulnerability (Businessdictionary, 2013). Leverage, which is a fundamental principle of speculative financial transactions, provides its holder with a possibility to trade with a whole range of rate risk and this risk is often very difficult to estimate. The problem of derivative financial instruments is that they allow its holder to simulate any financial activity because he has the opportunity to dispose of large volumes of assets and combine different types of exposures.

We can identify a trend in the financial markets of increasing concentration and accumulation of commercial activities associated with derivatives and their connecting to larger units. Systemic risk created during the crisis by global systemically important financial institutions, which unsustainably interlinked risks in the derivative market, is an alarming danger.

5 THE FAILURE OF ETHICS DURING THE FINANCIAL CRISIS

In this part of the present article we would like to note some examples of the problematic areas where the ethics in financial markets has already collapsed.

Nowadays the question of ethics is mostly discussed in the financial sector and many economists emphasize the fact that the global financial crisis (2008) was primarily the crisis of solvency and trust, the crisis of society values where moral hazard at all levels has played the most significant role.

Moral hazard has become one of the most important issues of the global financial crisis and the main problem was that it had occurred at different levels and in different forms. We defined moral hazards as excessive expenditure due to eligibility for insurance benefits (Marshall, 1976, p. 881). According to the OECD (2013), moral hazard describes behavior when agents do not bear the full cost of their actions and are thus more likely to take such actions. The *Financial Times Lexicon* adds that moral hazard arises when a contract or financial arrangement creates incentives for the parties involved to behave against the interest of others (FT LEXIKON, 2013). In the last definition we noticed the part describing a targeted behavior against the interest of others that is in contradiction with the Golden rule representing ethical behavior defined in the first sections of this paper.

The monetary policy of the Federal Reserve System (Fed) in the United States in the beginning of the 21st century could be described as moral hazard behavior at the level of the bank system. Fed started to gamble with interest rates through constant reduction of them to very low niveaus with the aim to stimulate investment activities in the domestic economy. The intention was fulfilled and inhabitants of the United States had an easy access to mortgage loans. Low interest rates and the availability of "cheap" money caused a price deformation and distorted information about the real market prices. The results of artificially created "cheap" money by the Fed were also greatly inflated investment demands, particularly in the mortgage market. Expansionary monetary policy of the Fed meant a purchase of government securities or in other words the issu**e** of uncovered and inflated money in circulation.

Moral hazard appeared also on the governmental level in form of rescue packages provided by the government of the United States in several ways. Thanks to the absence of comprehensive rules of selection of companies for financial assistance, the government favored larger companies over smaller ones. Although the fall of Lehman Brothers was an exception, governments have usually followed the "too big to fail" rule. Government intervention, toxic assets repurchase or financial assistance actually mean the spending of taxpayers' money for rescuing private banks and companies that had made the wrong business decisions and were responsible for unethical behavior. Large companies have changed to an attitude of risk with the possibility of being saved by a rescue package; they started to rely on government assistance and gained a benevolent approach to risk.

Reparations and compensations for the main actors of the crisis (executive directors and managers of large investment companies) in the form of so-called golden parachutes were another form of institutionalization of moral hazard. According to the dictionary, golden parachutes are substantial benefits given to a top executive in case that the company is taken over by another company and the executive is terminated as a result of the merger or takeover. The question is whether it is ethically acceptable to reward directors and managers, who led their companies to bankruptcy. According to OECD (2003, p. 2), customers believe that the financial institutions are "ethical" (in the sense that they observe rules for behavior that protect customers' interests) which makes them willing to entrust these institutions with responsibility to manage their assets. The ability to credibly commit to ethical behavior has always been a core business requirement for financial institutions. The importance of ethically correct behavior of companies or institutions was correctly expressed in Curtis's work *The Financial Crisis and the Collapse of Ethical Behavior* with these words: "When a corporation behaves ethically, it might be functioning well or poorly, and it might be a good or bad firm to invest in, but at least we know how it will behave: it will obey the law, treat its employees respectfully, be honest in its public disclosures, honor its commitments, be a good citizen in the communities where it operates, and so on. But when a corporation behaves badly, we have no idea what to expect." (Curtis, 2008, p. 10) In every market a certain degree of predictability significantly helps market subjects make rational decisions.

6 CONCLUSIONS

In the present paper, we have outlined a few aspects describing the relation between ethics and financial markets, and its importance for the functioning of financial markets. Because ethics could be perceived as a subjective category in economics, we would like to conclude the present article with a brief summarization of the status of ethics in form of questions resulting from the article. In our opinion, the following questions (and statements) are important for further discussion:

(1) Two centuries ago the question of whether speculation itself is ethically permissible and whether it is possible to justify using speculation on the market was examined. Is it not necessary to consider and discuss once again the question whether at present, speculation itself is ethically permissible.

(2) Information in current financial markets could be defined as highly expensive, distorted, and inadequate and each participant evaluates them in a different way. Is it possible to preserve a certain way of ethical objectivity of market subjects' behavior in case that they are owners of different information?

(3) Relations between creditors and debtors have to be inevitably built on trust and control. Could a sustainable credit policy of institutions and companies be built without responsibility and credibility?

(4) Leverage, a fundamental principle of financial derivatives, provides a possibility to trade with a whole range of rate risk which is often very difficult to estimate. Is it ethically correct to develop such financial instruments which allow its holder to simulate any financial activity and to provide an opportunity to dispose large volumes of assets and combine different types of exposures?

(5) Many derivate financial instruments are created by using a high degree of leverage that causes illusion of increasing perceived value of the underlying

asset. Could we consider an increase in the price caused by illusion (as opposed to by real value growth) as ethically correct?

(6) A certain group of companies, which at the time of the euphoria phase of the bubble had used to fund their costs by risky finance methods, began to ensure liquidity with even riskier and more dangerous way of funding in the panic phase. Is it ethically acceptable that after the bubble burst, some companies started to gain missing liquidity by hazardous behavior with a high level of risk and therefore contributed to the formation of the systematic risk?

(7) Moral hazard has become one of the most important issues of the global financial crisis and the main problem was that it has occurred at different levels and in different forms. What went wrong in financial markets during the crisis, that moral hazard had appeared as significant on all levels? Would moral hazard even exist if every individual who becomes an actor in the financial market followed ethics and tried "not treat others in ways that he would not like to be treated?"

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