TRUST Finance

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PR2: Sustainable Finance

Index – PR2

- Corporate Governance
- Trends and Paris Agreement
- Biodiversity finance
- Ethics and Fraud

PR2: Session 1

Corporate Governance

Corporate Governance - Introduction

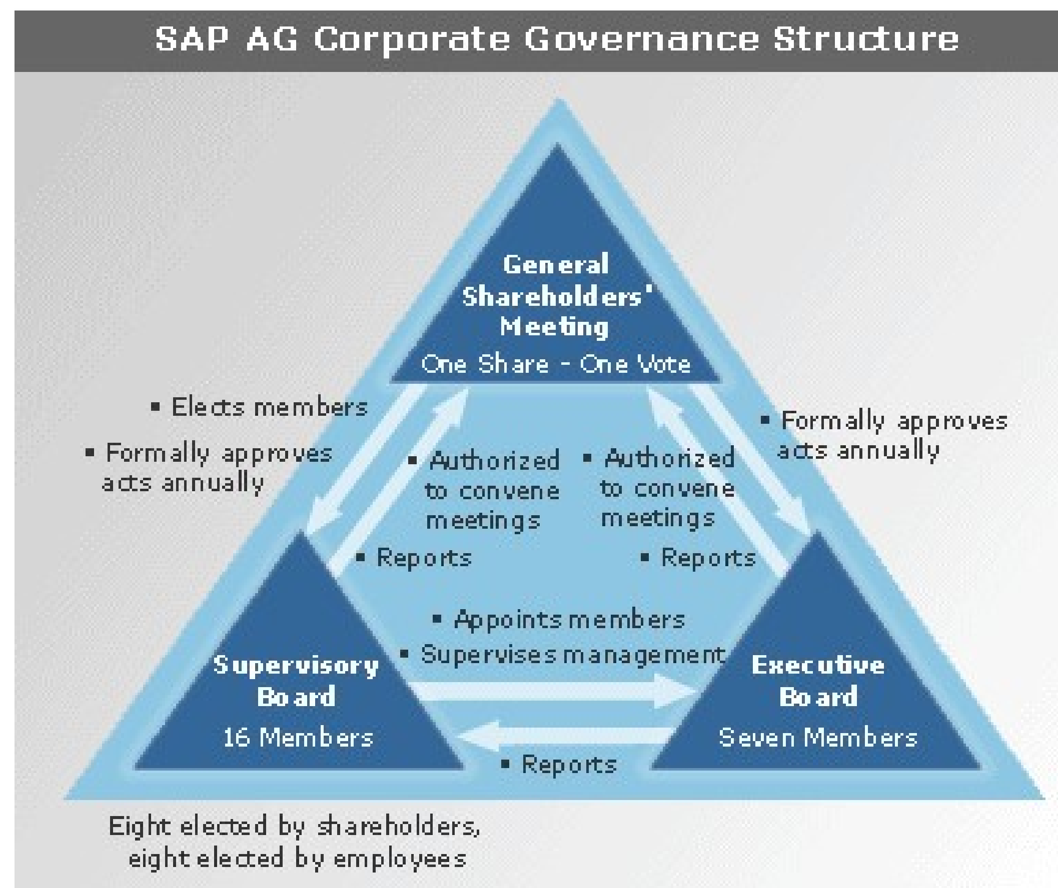
- **Corporate governance** is the set of laws, policies, processes, customs, and institutions affecting the way a corporation (or company) is directed and controlled (Cadbury Report, 1992).
  - external dimension:
    - laws and regulations
    - values and norms
  - internal dimension:
    - written down, manifested in documents
    - customs and traditions, “unwritten” rules
  - external actors: governmental institutions and other stakeholders
  - internal actors: board of directors (management), board of supervisors, shareholders, employees

Corporate Governance - Definition

- Definitions:
  - "Corporate Governance Deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on investment" (Shleifer and Vishny, 1997).
  - "A set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives, and monitoring performance, are determined" (OECD, 1999).
  - " The framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with all its stakeholders (financiers, customers, management, employees, government, and the community)" (Business Dictionary, 2011).

Corporate Governance - Example

- Corporate Governance at SAP



Corporate Governance - Example

- Corporate Governance at AGC

Management oversight
Business execution
Mutual cooperation
General Meeting of Shareholders
Corporate Auditors: 4 auditors (including 3 outside corporate auditors)
Board of Directors: 7 directors (including 3 outside directors)
Nominating Committee: 5 directors (including 3 outside directors)
Compensation Committee: 5 directors (including 3 outside directors)
Independent Accountants
President & CEO
Executive Vice President & CTO
Senior Executive Officer & CFO
Executive Officers
Management Committee
CSR Committee
Compliance Committee
Fair Trade Committee
Information Management Council
Security Export Control Headquarters
Internal Audit Office
Group Corporate
In-House Companies/Strategic Business Units (SBUs)
Group corporate function
Business operations function

Corporate Governance – Why do we need it?

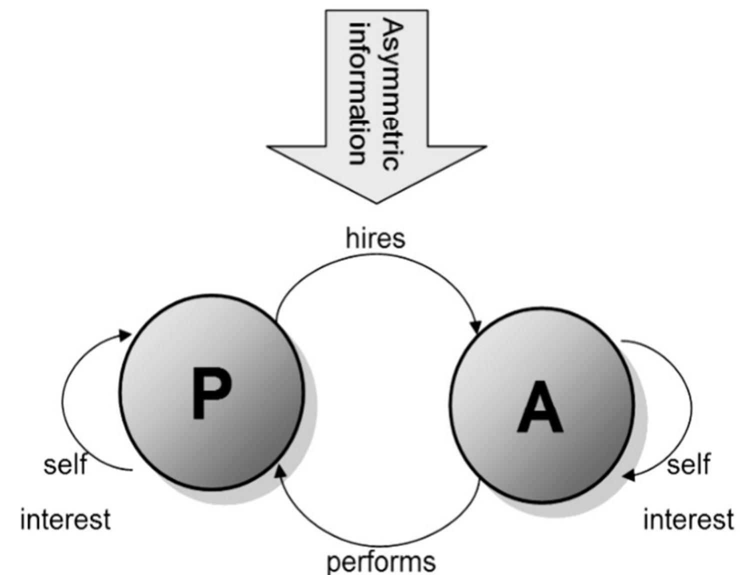
- Important reasons why we need CG:
  - ensures that an appropriate system of control works within a company and helps to protect assets
  - prevents single individuals from having too much influence
  - concerned with the relationship between the board of directors, the management, the shareholders, and other stakeholders
  - ensures that the company is managed in the best interests of the shareholders and the other stakeholders
  - attempts to foster transparency and accountability, which investors are looking for in corporate management as well as in corporate performance.

Agency Theory

- One party, the principal, delegates work to another party, the agent.
- In the context of the modern corporation, the owners are the principal and the directors are the agent.
- “The directors of companies, being managers of other people’s money, cannot be expected to watch over it with the same vigilance with which they watch over their own” (Adam Smith, 1776).

Agency Theory

- Problems primarily arise with regard to the self- interest of the agent:
  - misuse of power for pecuniary or other advantages
  - inappropriate risk taking
  - information asymmetry



Agency Theory

- Purpose of CG: Minimize the problems that result from the principal-agent relationship.
- Principal-Agent Problem as Core to the Modern Corporation:
  - separation of ownership (many diverse shareholders) and control => "ownership without power"
  - improving transparency and accountability as parts of CG to reduce information asymmetry
- Empirical evidence shows that firms with good governance show better financial performance (Selvaggi and Upton, 2008).

Agency Theory

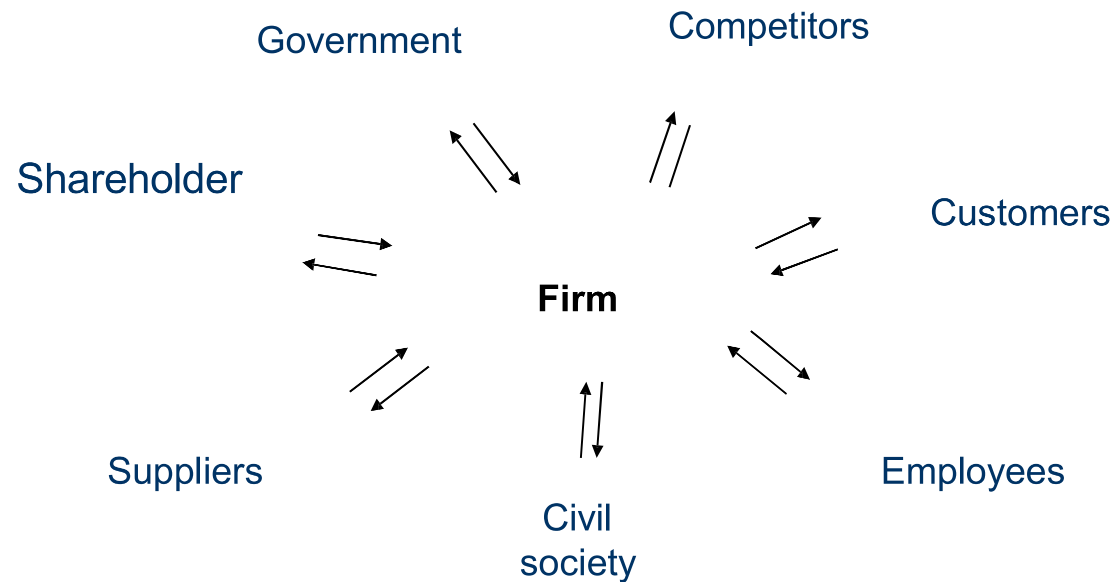
- Criticisms:
  - focus on purely quantitative metrics
  - studies which showed that companies with executive directors perform better
  - agency theory assumes that the investor will have a long- term perspective; however, we often find a rather short- term orientation
  - assumption that man is driven exclusively by self-interest
  - exclusive focus on shareholders

Stakeholder Theory

- Unlike agency theory, stakeholder theory does not only consider shareholders as relevant.
- no overriding focus on shareholder-value
- companies need to recognize their responsibility to all groups in society which are affected or can affect a company’s decisions.
- This responsibility is seen by many as the price a company has to pay for incorporation.

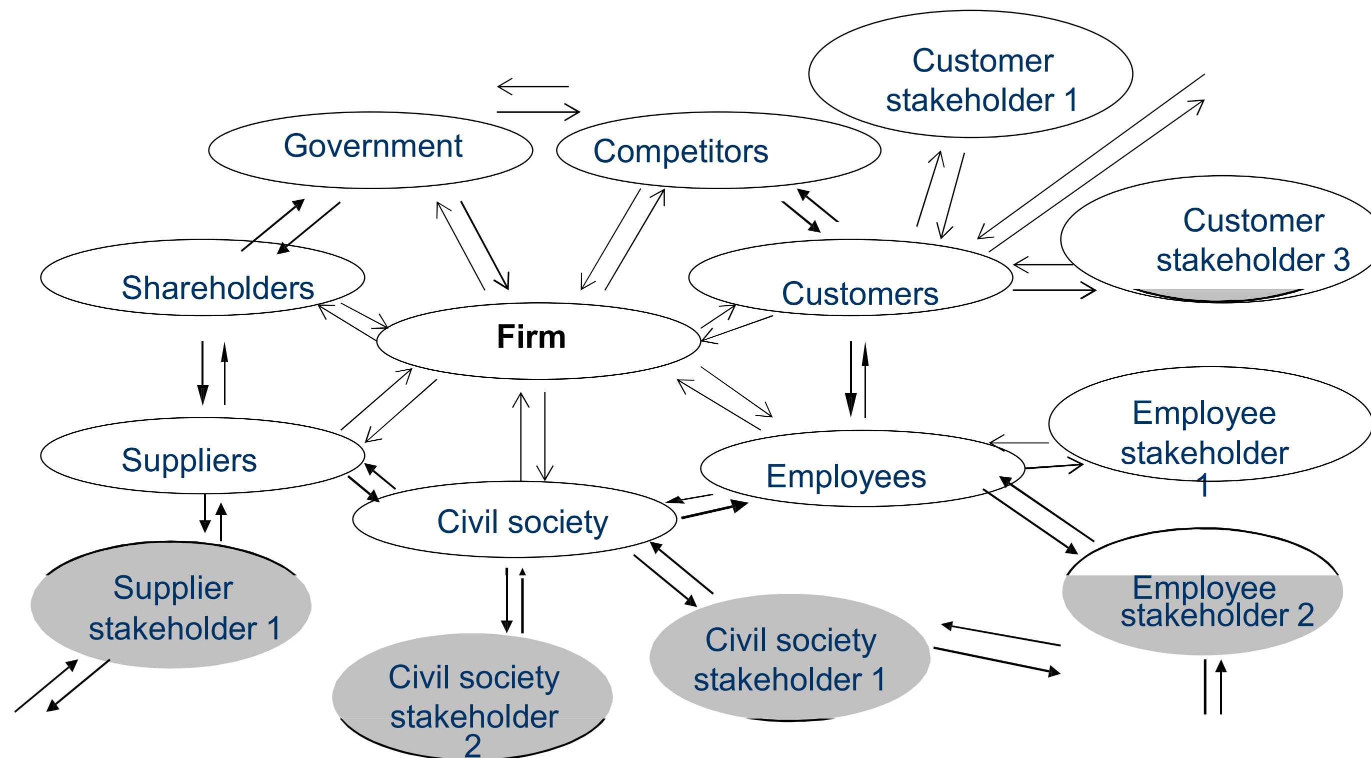
Stakeholder Theory

- Traditional Stakeholder Model



Stakeholder Theory

- Modern Stakeholder Network-Model

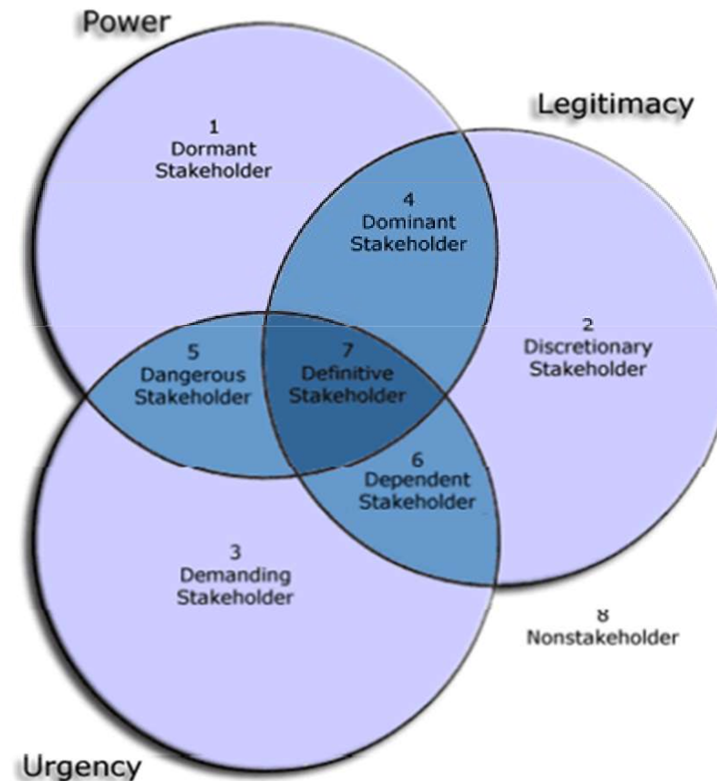


Stakeholder Theory

- Criticism:
  - conflicts between the interests of stakeholders are inevitable, whereas shareholder value is a clear and measurable standard
  - difficult for the management which stakeholder interests to consider
  - infinite number of potential stakeholders

Stakeholder Theory

- Solutions:
  - Maximization of shareholder value while taking into account stakeholder interests
  - Models to determine the importance of stakeholders (e.g. by Mitchell et al., 1997).



PR2: Session 2

Trends and Paris Agreement

Classical Finance

The "Classic" Finance Triangle

Sustainability

Return

Risk

Liquidity

Classical Finance

Risk and Return

Return (%)

Foreign Investments;
Real Estate;
Options; Futures Contracts
Small Corporations (Stock)
Large Corporations (Stock)
Long-Term Debt
Intermediate-Term Debt
Money Market Securities
Risk-free
Treasury Bills;
Federally Insured
Bank Accounts

Risk (σ)

Classical Finance

Pure Economics (Neo-Classical)

The 3 pillars of Pure Economics

i. Individuals are rational (not guided by emotions) and choose rationally among outcomes that can be identified and be associated with a value.

ii. Individuals maximize utility and firms maximize profits.

iii. People act independently on the basis of full and relevant information (everyone has access to the same, timely and costless information)

Classical Finance

“Schizophrenia“ (?)

- Theoretically, Finance as a discipline is a primarily neutral, technical and positive discipline that deals with “what is, what happens when, and how questions“. Not with (explicit) normative(!) “what should be or why?“ questions.
- As a matter of fact though, Financial Theories undertake the implicit final goal of shareholder wealth maximisation.

This leads to oversimplification and disregard of the relevant ethical implications

Trends: Sustainable Finance

What is Sustainable Finance?

The European Commission defines it as -

Sustainable finance refers to the process of taking **environmental, social and governance (ESG) considerations** into account when making investment decisions in the financial sector, leading to more long-term investments in sustainable economic activities and projects.

Environmental considerations might include climate change mitigation and adaptation, as well as the environment more broadly, for instance the preservation of biodiversity, pollution prevention and the circular economy.

Social considerations could refer to issues of inequality, inclusiveness, labour relations, investment in human capital and communities, as well as human rights issues.

The **governance** of public and private institutions – including management structures, employee relations and executive remuneration – plays a fundamental role in ensuring the inclusion of social and environmental considerations in the decision-making process.

Source: https://finance.ec.europa.eu/sustainable-finance/overview-sustainable-finance_en

Sustainable Finance

Sustainable finance products can use a range of approaches - individually or in combination - to deliver their goals. These approaches include:

- Exclusionary screening: excluding companies involved in certain activities or industries.
- Best-in-class investment: investing in companies that lead their peer groups in respect of sustainability performance.
- Norms-based investment: excluding companies that fail to meet internationally accepted norms.
- Thematic investment: investing in sustainability-related themes or assets.
- ESG integration: including ESG risks and opportunities into financial analysis and investment decisions.
- Governance impact and active ownership: Engaging with investee companies on sustainability issues and policies.
- Impact investment: investing to achieve specific, positive social benefits along with financial returns.

Sustainable Finance

It pays to be good

EXHIBIT 3 | Margin Premiums Are Linked to Strong Performance in Certain ESG Topics

CONSUMER PACKAGED GOODS

- Conserving water
  - 3.1 pp EBITDA
  - 5.5 pp Gross Margin
- Ensuring a responsible environmental footprint
  - 1.3 pp EBITDA
  - 3.3 pp Gross margin
- Limiting negative effects on biodiversity and ecology
  - 3.0 pp EBITDA
- Minimizing impact of products and packaging
  - 4.1 pp EBITDA
  - 12.4 pp Gross margin
- Promoting employee safety
  - 3.3 Gross margin
- Socially responsible sourcing
  - 4.8 pp Gross margin

BIOPHARMACEUTICALS

- Conducting ethical human clinical trials
  - 6.1 pp EBITDA
  - 6.3 pp Gross margin
- Expanding access to drugs
  - 8.2 pp EBITDA
  - 6.7 pp Gross margin
- Promoting employee safety
  - 4.6 pp EBITDA
  - 4.8 pp Gross margin
- Promoting transparent lobbying
  - 5.1 pp EBITDA

OIL AND GAS

- Maintaining process-oriented health and safety programs
  - 3.4 pp EBITDA
- Supporting ongoing employee training
  - 8.2 pp EBITDA
  - 6.3 pp Gross margin

RETAIL AND BUSINESS BANKING

- Avoiding and combating corruption
  - 2.3 pp Net income margin
- Ensuring fair debt collection
  - 0.5 pp Net income margin
- Ensuring fair selling practices
  - 0.4 pp Net income margin
- Environmentally responsible sourcing
  - 3.4 pp Net income margin
- Promoting financial inclusion
  - 0.5 pp Net income margin

Sources: Oekom Research; MSCI; SASB; BCG analysis.
Note: ESG = environmental, social, and governance. Figures represent the average margin premium (in percentage points) of top performers (90th percentile) in the specific ESG topic compared with median performers (50th percentile), all else being equal.

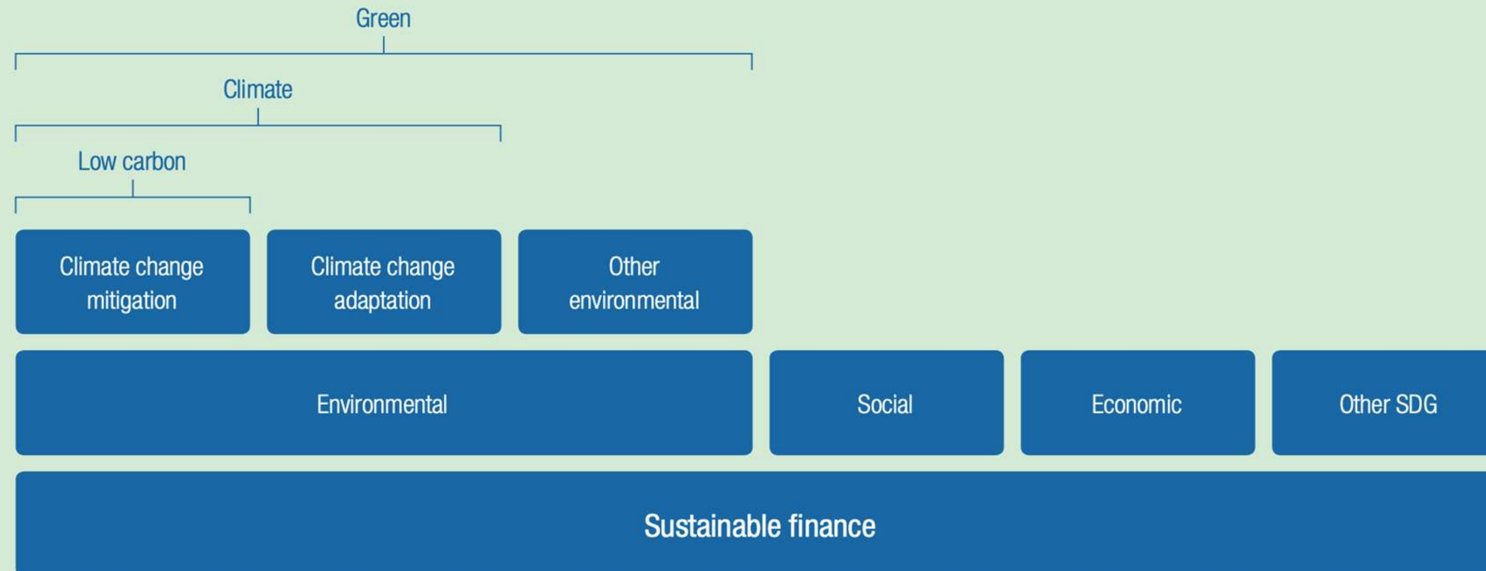
Sustainable Finance

Climate Finance

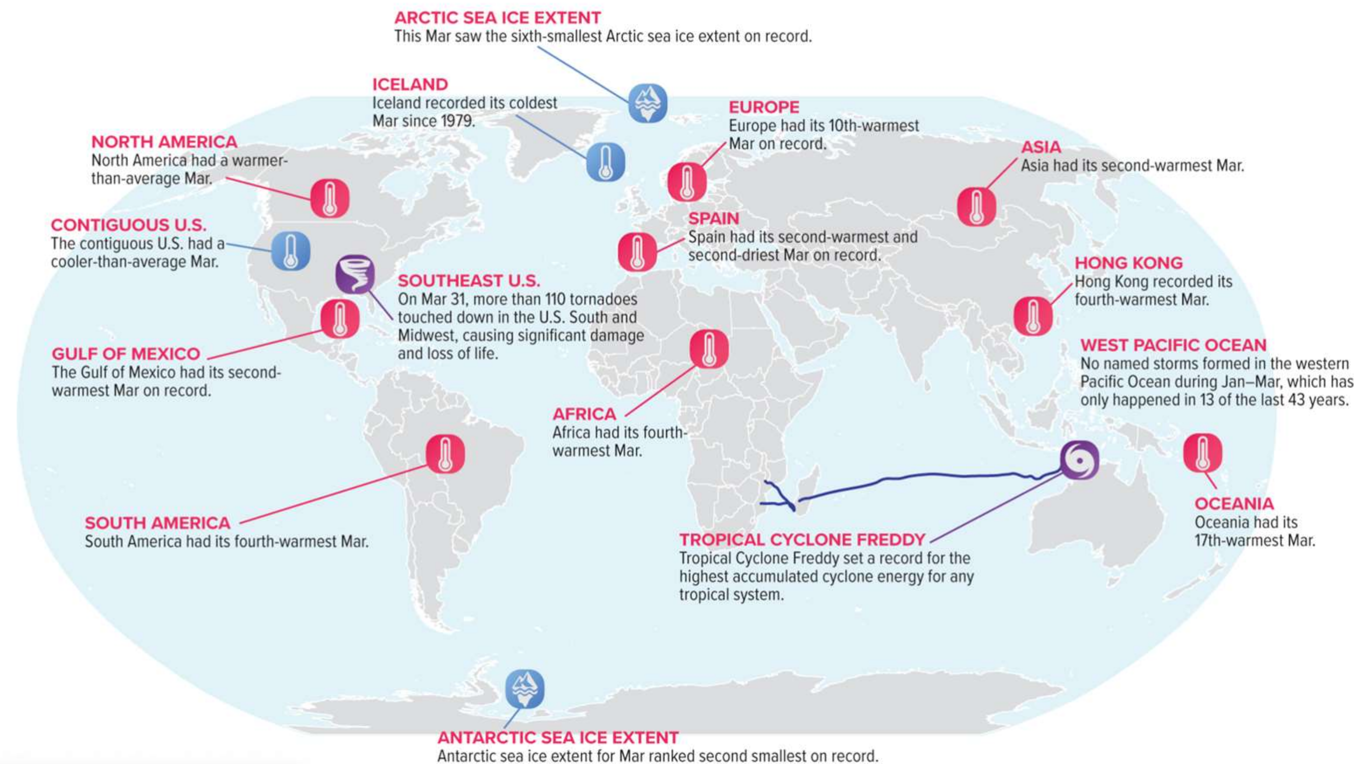
Box I.2 **Green finance terminology (Source: UN Environment Inquiry)**

Climate Finance is defined by the United Nations Framework Convention on Climate Change (UNFCCC) as 'local, national or transnational financing, which may be drawn from public, private and alternative sources of financing… to significantly reduce emissions, notably in sectors that emit large quantities of greenhouse gasses… and to adapt to the adverse effects and reduce the impacts of climate change'.

Sustainable Finance can be understood as stocks and flows of financial resources and assets (across banking, investment and insurance) which is aligned with a broader range of environmental, social and economic objectives - most fundamentally, the delivery of the SDGs.

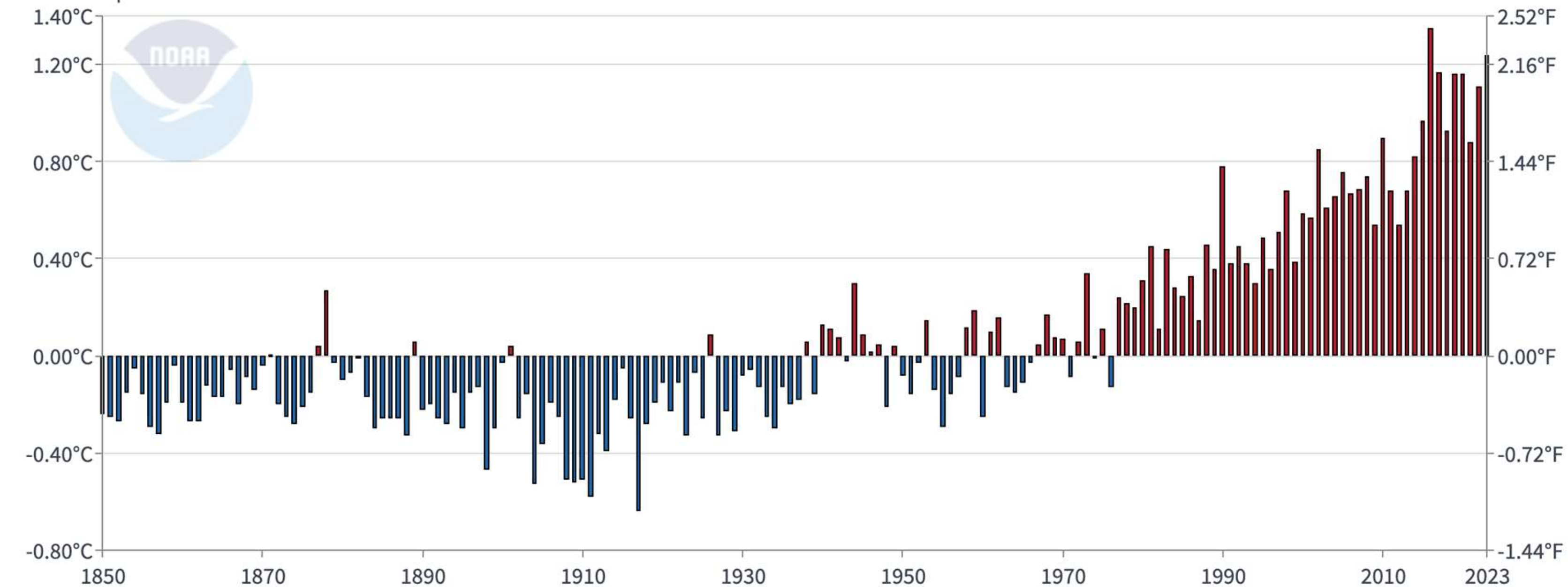


Paris Agreement - Background

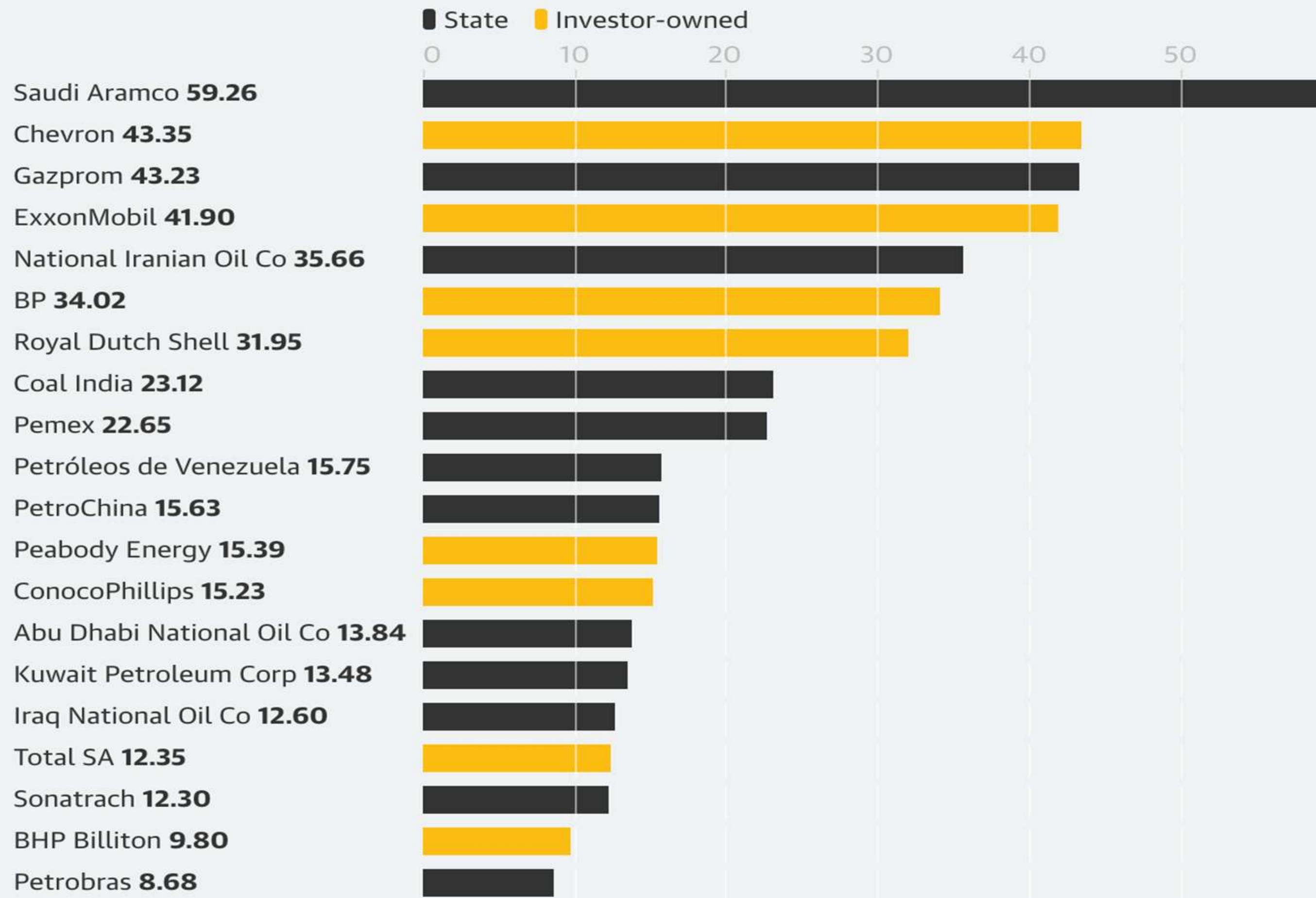


Source: National Centres for Environmental Information
https://www.ncei.noaa.gov/access/monitoring/monthly-report/global/202303

Paris Agreement - Background



Source: National Centres for Environmental Information
https://www.ncei.noaa.gov/access/monitoring/monthly-report/global/202303



Source: “Revealed: the 20 firms behind a third of all carbon emissions”, The Guardian Oct 9, 2019

Climate Finance

Your own carbon footprint

- Please undertake the WWF carbon footprint calculator and reflect on your results:
- https://footprint.wwf.org.uk/
- Find your activity with the highest carbon footprint;
- Can you identify a solution/alternative?

- http://www.globalcarbonatlas.org/en/CO2-emissions

Kyoto Protocoll 1997

- The Kyoto Protocoll was adopted on 11th Dec 1997. It entered into force in 2005. Currently there are 192 parties to the Kyoto Protocoll. It operationalises the United Nations Framework Convention on Climate Change by committing industrialised nations and economies in transition to limit 6 main GHG emissions* in accordance with agreed individual targets.

*Carbon Dioxide, Methane, Nitrous Oxide, Hydrofluorocarbons, Perfluorocarbons, and Sulphur Hexafluorides

Paris Agreement 2016

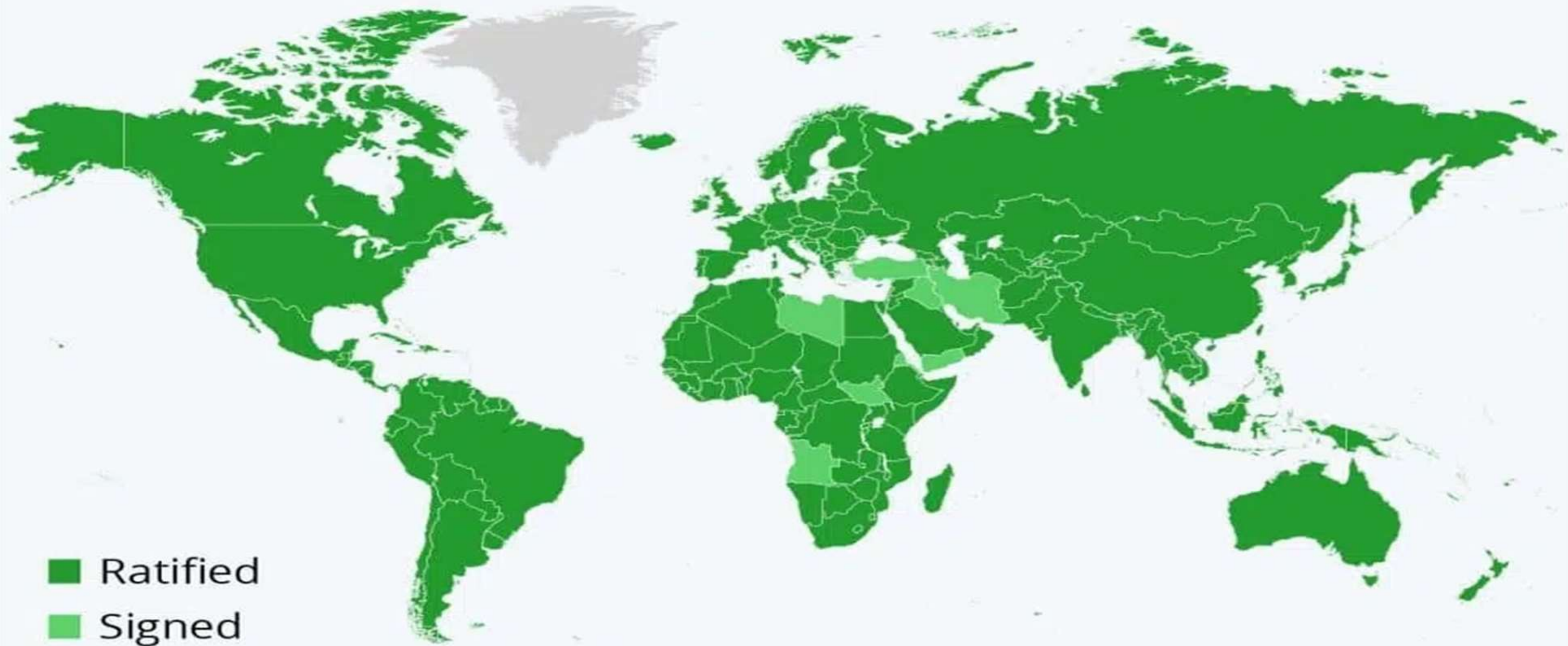
The Paris Agreement is a legally binding international treaty on climate change.

- The first time, a binding agreement brings all nations together to combat climate change and adapt to its effects.
- Adopted by 196 Parties at the UN Climate Change Conference (COP21) in Paris, France, on 12 December 2015. Came into force on 4 November 2016.
- Overarching goal is to hold "the increase in the global average temperature to well below 2°C above pre-industrial levels" and pursue efforts "to limit the temperature increase to 1.5°C above pre-industrial levels."

https://unfccc.int/process-and-meetings/the-paris-agreement

The State of the Paris Agreement

Countries by their participation in the Paris Agreement
(as of April 21, 2021)



Source: UNFCC

statista

Paris Agreement (PA)

- PA works on a five-year cycle of ratcheting up by countries involved.
- Since 2020, countries have been submitting their national climate action plans, known as nationally determined contributions (NDCs).
- Accelerated action is required to limit global warming to 1.5°C,
- By end 2023 parties to revisit and strengthen the 2030 targets

https://unfccc.int/process-and-meetings/the-paris-agreement

Paris Agreement – how are countries supporting one another

- PA provides a framework for financial, technical and capacity building support to those countries who need it.
- PA affirms developed countries take lead in providing financial assistance to more vulnerable and less endowed countries
- Climate finance is needed for mitigation, because large-scale investments are required to significantly reduce emissions.
- Climate finance is equally important for adaptation, as significant financial resources are needed to adapt to the adverse effects and reduce the impacts of changing climate.
- The major emitting countries that have yet to formally join the agreement are Iran, Iraq and Turkey.

https://unfccc.int/process-and-meetings/the-paris-agreement

Paris Agreement – in summary

- Limit global temperature rise by reducing greenhouse gas emissions.
- Provide a framework for transparency, accountability, and the achievement of more ambitious targets.
- Mobilise support for climate change mitigation and adaptation in developing nations.

Other Developments

COPs - Climate Change Conference of the Parties

COP26: They signed the Glasgow Climate Pact

- Agreed on the Paris Rulebook
  - An enhanced transparency framework for reporting emissions
  - Common timeframes for emissions reduction targets
  - Mechanisms and standards for international carbon markets

COP27

- Did not achieve much. Was unable to reach an agreement on phasing out coal and other fossil fuels or setting emission peak periods. Impedes efforts to limit global average temperature increase to 1.5 degree celsius.
- However it was agreed to establish a fund for responding to climate change related loss and damage

COP28

- Held in Dubai and ended with an agreement that signals the „beginning of the end of the fossil fuel era“

PR2: Session 3

Biodiversity Finance

Biodiversity (&) Finance

Definition: Biodiversity represents the variety of life in terms of different species of birds, mammals, insect and different ecosystems. **This includes: diversity within species (such as genetic variation between different strains of grain like wheat); variation between different species (such as different species of farmland birds); and variation of ecosystems.** (Introduction to Environmental Economics, 2013)

- The provision of finance to support biologically diverse ecosystems – or alternatively to support the biodiversity of a stock of natural capital ensures the reliable provision of ecosystem services from the world's stocks of natural capital.
- This, by extension, ensures that the stock of natural capital and the services they provide are more resilient to shocks and changing physical environments – a necessity in the face of widespread impacts of climate change (World Bank 2020).

Biodiversity - background

To date, around 1.8 million different species have been discovered and documented (Vié et al. 2009)

The best working estimate of the total number of species, documented and undocumented, on Earth is around 8 million, 75% of which are insects (IPBES 2019).

Biodiversity loss is among the top global risks to society.

The planet is now facing its sixth mass extinction, with consequences that will affect all life on Earth, both now and for millions of years to come.(OECD, 2019)

Source: Biodiversity: Finance and the Economic and Business Case for Action, Prepared by the OECD for the French G7 Presidency and the G7 Environment Ministers' Meeting, 5-6 May 2019

Biodiversity - background

- Biodiversity, healthy ecosystems, and the survival of species all have intrinsic value, but their **instrumental value to humans is provided through the products and services we obtain from ecosystems** and is best described using the term “ecosystem services”.

- Like produced capital, such as a water treatment facility that improves water quality, natural capital provides a vital flow of ecosystem services. Ecosystem services are functions of an ecosystem that directly or indirectly benefit human wellbeing (Daly and Farley, 2004; Voldoire and Royer 2004).

Biodiversity (&) Finance

- Business and financial organisations also depend on biodiversity and ecosystems services for the production of goods and services.
  - Coral reefs alone generate USD 36 billion per year for the global tourism industry.

- Biodiversity loss can have direct implications on business operations and value chains, e.g. by increasing input costs.
  - Relevant risks to business and financial organisations include ecological risks, i.e. operational risks related to biodiversity impacts and resource dependency, liability; scarcity and quality risks.
    - For example: risk of legal suits; regulatory risks; reputational and market risks, linked to stakeholders’ pressures or preferences changes; and financial risks

Biodiversity (&) Finance

Biodiversity protection is fundamental to achieving food security, poverty reduction and more inclusive and equitable development.

- According to the World Economic Forum, USD 44 trillion of economic value, or over half of the world's GDP, is moderately or highly dependent on nature, and therefore currently at risk as a result of biodiversity loss and ecosystem degradation (WEF and AlphaBeta 2020).
- Over 1.6 billion people are dependent on forest services with 300–350 million depending entirely on forests for shelter and subsistence (Butler 2019)
- The annual market value of crops dependent on animal pollination ranges from USD 235 billion to USD 577 billion. (Butler 2019)

Biodiversity (&) Finance – The outlook

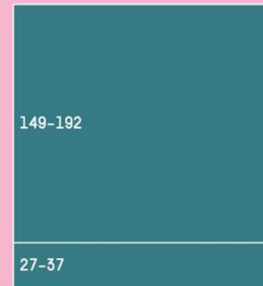
McKinsey estimates that

- increasing the global protected area coverage by creating or safeguarding protected areas through conservation efforts – would give benefits of USD 290–470 billion per year.
- It would also create 400,000 to 650,000 jobs in conservation management, 30 million jobs in ecotourism and sustainable fishing, and reduce annual CO_2 emissions by 0.9 to 2.6 giga annually (Claes et al. 2020).

"Firms ignoring climate crisis will go bankrupt" says Mark Carney, the Bank of England Governor, (The Guardian Oct 13, 2019)

What's needed

Global biodiversity funding needs by 2030



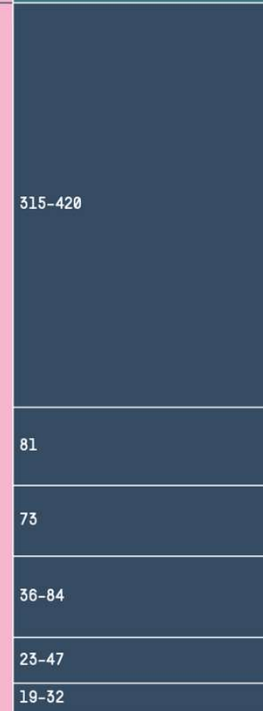


Figure 1.
Global annual biodiversity conservation funding needs (upper estimate).

Source: The little book of investing in nature, Global Canopy.

The future….
some solution(s)

- Payments for ecosystem services (PES) was defined by Wunder (2005) as "A voluntary transaction where a well-defined ecosystem service is being bought by an ES buyer from an ES provider if and only if the ES provider secures ES provision (conditionality)."
- PES is one of the most commonly used mechanisms to generate revenue for biodiversity conservation.
  - PES schemes provide benefits to landowners who preserve ecosystem services (ES) to disincentivise them from using the land for different purposes, such as deforestation.
  - They are used to incentivise land users to properly manage and conserve their natural environment, thus ensuring the flow of ecosystem services (Pagiola and Platais 2002).

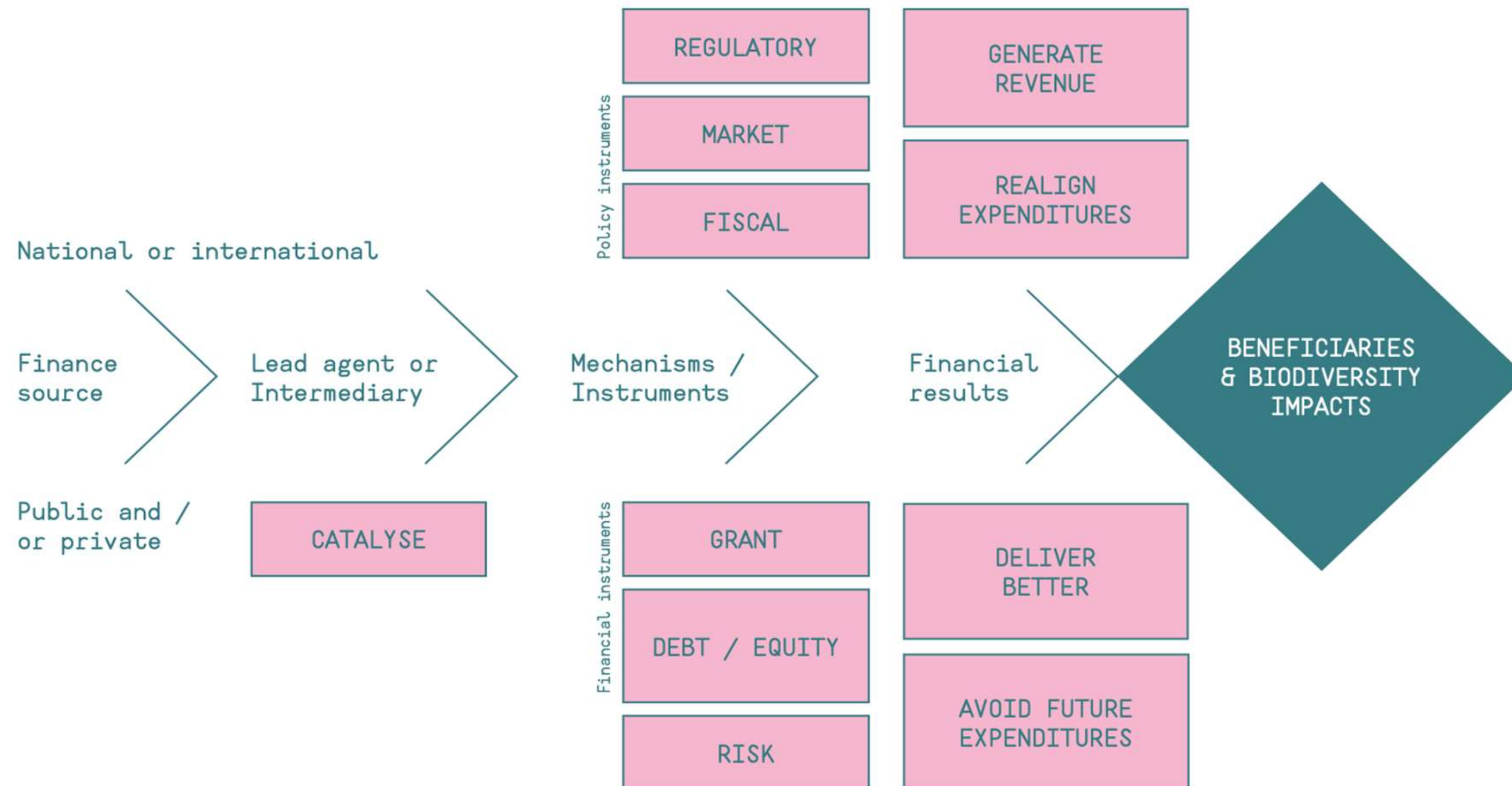
The future....

some solution(s)

- A ‘biodiversity finance solution’ as advocated by UNDP BIOFIN is an **integrated approach to improve biodiversity outcomes and reduce negative pressure on biodiversity** by the use of context-specific biodiversity finance mechanisms.

- Each biodiversity finance solution is built on a combination of elements that may include one or more financial instruments or mechanisms, financing sources, lead agents or intermediaries, beneficiaries or principal stakeholders, and the desired financial result (UNDP 2018).

Biodiversity Finance



Modified from UNDP BIOFIN (2018)

- Schematic diagram of biodiversity finance solutions

PR2: Session 4

Ethics and Fraud in Finance

Ethics and Fraud

"So the question is, do corporate executives, provided they stay within the law, have responsibilities in their business activities other than to make as much money for their **stockholders** as possible? And my answer to that is, **No They Do Not**"

Nobel Prize Winning Economist : Milton Friedman

Ethics and Fraud

Exxon Mobil, Shell

In the Canadian Boreal forest just downstream of the eastern foothills of the Rocky Mountains are the Canadian tar sands. The region contains some 2 trillion barrels of oil, but getting to it will mean destroying an area larger than the state of Florida. Tar sands consist of heavy crude oil mixed with sand, clay and bitumen. Extraction entails burning natural gas to generate enough heat and steam to melt the oil out of the sand. As many as five barrels of water are needed to produce a single barrel of oil.

Tar sands oil is the worst type of oil for the climate, producing three times the greenhouse gas emissions of conventionally produced oil because of the energy required to extract and process tar sands oil. Communities downstream from the tar sands mines report elevated levels of cancer that they blame on toxic contamination of the Athabasca River.

Ethics and Fraud

MONSANTO (now Bayer)

Monsanto produced PCBs for over 50 years. The U.S. Environmental Protection Agency says, **“PCB has been demonstrated to cause cancer, as well as a variety of other adverse health effects on the immune system, reproductive system, nervous system and endocrine system.”** The evidence and internal company papers show that ***Monsanto knew about the PCB dangers*** from very early on.

Monsanto produces **Lasso herbicide**, better known as ***Agent Orange***, which was used as defoliant by the U.S. Government during the Vietnam War.

Monsanto began manufacturing the herbicide **Roundup**, which has been marketed as a "safe", general-purpose herbicide for widespread commercial and consumer use, even though its key ingredient, **glyphosate**, is a highly toxic poison for animals and humans.

Monsanto produces *Cycle-Safe*, the **world's first plastic soft-drink bottle**. The bottle, suspected of posing a **cancer risk**, is banned the following year by the Food and Drug Administration.

Monsanto found guilty of negligently exposing a worker to **benzene** at its Chocolate Bayou Plant in Texas. It is forced to pay $100 million to the family of Wilbur Jack Skeen, a worker who **died of leukemia** after repeated exposures.

Monsanto is sued after allegedly supplying radioactive material for a controversial study which involved **feeding radioactive iron to 829 pregnant women**.

Current Stock Price :$ 127 Bayer: €56,29

How does this happen?

Characteristics of Management Prone to Fraud

- Unduly aggressive financial targets
- Domination by person or group without controls
- Aggressive accounting practice to keep stock prices high
- Pressure to reduce tax liabilities
- Major performance related compensation
- Non-Financial personnel involved in accounting matters

How does this happen?

The usual suspects

- Financial statements
- Hostile Takeovers
- Financial Markets
- Insider Trading

How does this happen?

Fraud in Financial Statements

- Fictitious Revenues
- Concealed Liabilities and Expenses
- Fraudulent Asset Valuations
- Improper or Fraudulent Disclosures or Omissions
    - ➢Creative accounting – form of fraudulent financial reporting so as to provide misleading information. Enron

Creative Accounting

- **WorldCom, US, 2002** – Inflated stated assets by about $11bn, by capitalising rather than expensing line costs, hiked revenues with fake accounting entries
- **Nortel, Canada, 2003** – It was found that about $3bn in revenue had been booked improperly in 1998, 1999 and 2000. More than $2bn was moved into later years, about $750mn was pushed forward beyond 2003 and about $250mn was wiped away completely.
- **Lehman Brothers, US, 2008** – hid over $50bn in loans disguised as sales. (Allegedly) sold toxic assets to Cayman Island banks with the understanding that they would be bought back .Created an impression that it had $50bn more in cash and $50bn less in toxic assets.

In come the Auditors

- To give an accurate statement to the members about the state of affairs of a company
- To meet the objectives of the regulations
- To be reasonably skillful and careful in identifying the true nature of the accounts

In come the Auditors

- **Deloitte** fined a record £14 million for a conflict of interest in advising MG Rover. Sept 2013

- **PwC** fined record £1.4m over JP Morgan audit : PricewaterhouseCoopers stung with a record £1.4m fine for "very serious" misconduct over its audit of JP Morgan Securities, June 2012

- **PriceWaterhouse India**, the auditors of Satyam Computers, fined USD 6 million in penalty for conducting “deficient audits of the company's financial statements and enabling a massive accounting fraud to go undetected for several years. April 2011

- **E&Y** was fined £500,000 with costs of £2.4m for failing to warn Equitable policyholders of the society's problems a decade ago. Equitable Life closed to new business in 2000 and came close to collapse after failing to put sufficient funds aside to pay for the guaranteed payouts it had promised on some of the pension policies it had been selling from the 1950s until 1988. June 2010

JPMs Fines In Perspective

15,00,00,00,000
12,50,00,00,000
10,00,00,00,000
7,50,00,00,000
5,00,00,00,000
2,50,00,00,000
0

6/21/2011
2/9/2012
1/2/2013
9/19/2013
10/25/2013
11/19/2013
1/6/2014

Fine Amount

Highcharts.com

In come the Regulators

Duties (amongst others)

- Establish laws and accepted practices to aid ethical practice in corporate world
- Monitor and provide channels of disclosure for reporting corporate malpractices
- Penalise obvious bad apples
- Reassess, restructure and modify existing accepted rules to plug loopholes

In come the Regulators – fraud continues (US)

- Madoff Case - the former SEC chairman, has admitted multiple failures on part of SEC in this case. No investigation was conducted into the promised “curiously steady” returns fund which only invested with Madoff. The SEC has been accused of missing numerous red flags and ignoring tips on Madoff's alleged fraud. Involved member of SEC married to Madoffs niece after scandal became public.
- According to former SEC employee and whistleblower Darcy Flynn, the agency routinely destroyed thousands of documents related to preliminary investigations of alleged crimes committed by Deutsche Bank, Goldman Sachs, Lehman Brothers, SAC Capital, and other financial companies involved in the Great Recession that the SEC was supposed to have been regulating. The tradition of destruction began as early as the 1990s.

In come the Regulators – fraud continues (UK)

- The **FSA ignored warning signals** from Northern Rock building society and continued to allow the bank to operate without a risk mitigation program for months before the bank's collapse
- It was announced in November 2008, that despite self-acknowledged failures by the FSA in effectively regulating the financial services industry, **FSA staff would receive bonuses**. On 31 May 2008, The Times confirmed that FSA staff had received £20m in bonuses for 2008/09, a 40% increase on the previous year.
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Other issues in financial markets

- Deception: act of misrepresenting relevant information
- Churning: Excessive or inappropriate trading for clients account by a broker who has control over the account with intent to generate commissions rather than to benefit client
- Unsuitability
- Unfairness in Markets

THANK YOU FOR YOUR ATTENTION ☺

Ethical Issues in Financial Services

- Sales Practices
- Churning, Twisting & Flipping

Ethical Issues in Financial Services

- The financial services industry still operates largely though personal selling.
  - Most people know their insurance agents, financial planners, tax advisors personally
  - Personal selling creates innumerable opportunities for abuse and misconduct
- There are bad apples in every business but many critics fault the industry itself.
- Mutual funds and even banks now offer investors the opportunity to invest without the fear of being ripped off by a broker.

Sales Practices

- Two real estate limited partnerships launched by Merrill Lynch in 1987 & 1989 lost $440 million for 42,000 investors. Known as Arvida I (AI) & Arvida II (AII) these highly speculative investment vehicles projected double digit returns on residential developments in Florida & California. At end 1993 each $1000 unit or AI was worth $125 & each $1000 unit of AII a mere $6
- Merrill Lynch advised its own brokers that these were “moderate risk” investments.
- Left out crucial information like – the projections included a return of some of the investors own capital, the track record of the real estate company was based on commercial not residential projects and that 8 out of 9 managers of the company had left just before the AI was offered to public

Sales Practices

- Some investors in the AI&II claimed that the distinction between return ***on*** capital a return ***of*** capital was not clearly explained to them leading to misunderstandings about the cash flow projections

Another example

- In Nov 2013, JP Morgan agreed to settle claims worth $100 mln this year with a promise to settle $940 mln worth more in the coming years for misleading its investors about certain products

Conditions for deception

The FTC, the SEC and other regulators employ a 3-factor test:

1) how reasonable is the person who is deceived?

2) how easily could a person avoid being deceived?

3) how significantly is the person harmed by the deception?

- **First** – it is assumed a reasonable person can read and compare fine print – for e.g. teaser credit card rates. However misleading comparison of mutual funds performance that could lead even careful readers to conclude that a poorly performing fund is superior to competition is arguably deceptive.
- **Second** – potentially deceptive claims that can be easily countered by readily accessible info are less objectionable than claims that most people can accept only at face value.
- **Third** – deception that would lead a person to suffer a significant loss or some other grave harm is of greater concern to the regulators.

Examples for analysis

In order to examine some of the difficulties in the conditions for fair market exchanges that bear on whether claims are deceptive, consider the following situations:

1. A brokerage firm buys a block of stock prior to issuing a research report that contains a "buy" recommendation in order to ensure that enough shares are available to fill customer orders. However, customers are not told that they are buying stock from the firm's own holding, and they are charged the current market price plus the standard commission for a trade.
2. A broker assures a client that an initial public offering (IPO) of a closed-end fund is sold without a commission and encourages quick action by saying that after the IPO is sold, subsequent buyers will have to pay a 7 percent commission. In fact, a 7 percent commission is built into the price of the IPO, and this charge is revealed in the prospectus but will not appear on the settlement statement for the purchase.
3. The names of some mutual funds do not accurately reflect the fund's true investment objectives. One study showed that fewer than two-thirds of the funds classified as "growth and income" performed in a manner that is consistent with that investing style. However, the investment objectives of any fund are stated in the prospectus, and the current portfolios of all active funds are available for inspection.[4]
4. Insurance companies that sell variable annuities are permitted by the SEC to advertise with charts that project hypothetical returns

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4. Insurance companies that sell variable annuities are permitted by the SEC to advertise with charts that project hypothetical returns that do not include "mortality and expense risk" (M&E) charges for insurance coverage.[5] These charges, which range from 1.27 percent to 1.4 percent annually, must be disclosed in the text of all advertising. The insurance industry contends that omitting M&E charges from the hypothetical returns is necessary in order for investors to compare their variable annuities with those offered by mutual fund companies, which do not contain any insurance coverage.

Churning, Twisting & Flipping

- **Churning** is defined as excessive or inappropriate trading for a client's account by a broker who has control over the account, with the intent to generate commission rather than to benefit the client.

- **Twisting** refers to the practice by insurance agents of persuading policy holders to replace an older policy with a newer one that provides little if any additional benefit, but generates a commission for the agent.

- The corresponding tactic in commercial loan business is called **Flipping**. A loan officer who "flips" a customer manages to replace an existing loan with a new one that usually provides the customer with some additional cash. In one case, an illiterate retiree with equity in a home was flipped 10 times in a four-year period as an original $1250 loan grew to $45000. The victim paid $19000 in loan fees for the privilege of borrowing $23000 – the fees therefore amounted to 83% of the loan proceeds.

WHY DOES THIS HAPPEN?

SOME POSSIBLE REASONS….

Doctrines of New Finance

- The irrelevance Theorem: developed by Modigliani and Miller this theorem holds that under ideal market conditions a firm's financial policy is irrelevant.
  - Practically this means that managers should focus on non-financial decisions that can affect the firms valuation and investors should attend to the characteristics of their own portfolio and ignore those of individual firms.
- The efficient market hypothesis: in efficient capital markets, prices of securities accurately reflect all relevant information.
  - Practically this means little can be gained by controlling the release of information or by attempting to falsify information. The investors on the other hand are unlikely to beat the market by seeking out superior information.

Doctrines of New Finance cont'd..

- Capital Asset Pricing Model (CAPM): determines whether investors are receiving sufficient risk premium by comparing expected return of a risk adjusted portfolio to the return of riskless investments
  - Practically this means, investors should diversify so that they are affected only by systematic risk.
- Options Pricing theory: Shares of stock in a firm are functionally equivalent to an option to buy an asset of the firm from bondholders. The exercise price of the option is the face value of the bond and the exercise date is the maturity date of the bond

Ethical Implications

- Insofar as the New Finance has turned finance theory into a science that tells us what *is* instead of what *ought to be*, it is beyond ethical criticism.
- We can no more find moral fault with New Finance than we can blame our knowledge of physics for enabling us to develop the atomic bomb.
- However, the root problem of New finance, argue critics, is that it focuses managers' attention on certain aspects of their jobs and labels others as irrelevant

Ethical Implications Investors

- Beyond maximising shareholder wealth do managers have any obligation to consider shareholder preferences in other matters that affect their financial interests? i.e. choice of capital structure.
- The irrelevance theorem suggests that such concern is unnecessary. A potential consequence is that there is a neglect of all shareholders’ interests other than those concerned narrowly with share price.

Ethical Implications Investors

- If shares in a firm are viewed as options to buy or sell, as suggested by Options Pricing Theory, then the value of the shareholders’ option to ‘buy’ the assets of the corporation can be raised by increasing the riskiness of the firm’s operations.

Ethical Implications Employees

- High risk strategies that flirt with bankruptcy also affect employees along with customers, suppliers and the community at large.
- Employees are at a great risk because unlike investors they are unable to diversify. Their welfare is closely tied to the fortunes of the employing firm.
- Laid off employees can find other work – however, skills are usually firm specific.

Ethical Implications Employees

- Employees are vulnerable not only to the implications of Options Pricing Theory which may lead shareholders to devalue the firm as an ongoing concern, but also to the conclusion of CAPM that unique risk does not matter. Shareholder who are diversified are not exposed to unique risk but employees who make firm specific investments are vulnerable to all of the unique risks of the firm.

- Managing unique risk is at the heart of strategic management which is critical to the success of individual firms. But CAPM tells investors not to reward the managers of any individual form for successful strategic management that concerns itself with unique risks.

Ethical Implications Market

- The doctrines of New Finance are potentially disruptive of stock market because of the tendency towards increased volatility.
- Increased volatility is possible if managers following CAPM do not seek to limit unique risks.
- Or Options pricing theory could encourage shareholders to favour increased volatility of firms shares in order raise the value of their option.
- Moral hazard, where the benefits of decision flow primarily to the decision makers while the costs are borne largely by the society, would encourage high-risk strategies that increase volatility of firm's shares.
- Efficient market hypothesis would increase volatility if investors who believe that costly analysis cannot enable them to beat the market turn to long shot gambles.

Ethical Implications

- If finance theory is purely technical, however, and concerned only with the means and not ends, then perhaps we should look elsewhere for the guidance that would make the world ethically a better place.
- A world in which financial decisions makers pursue their own interests guided only by the doctrines of the New Finance would be, in the words of one critic, ‘ not a nice place ethically’.

In come the Regulators

Duties (amongst others)

- Establish laws and accepted practices to aid ethical practice in corporate world
- Monitor and provide channels of disclosure for reporting corporate malpractices
- Penalise obvious bad apples
- Reassess, restructure and modify existing accepted rules to plug loop holes

However fraud continues…
Regulators, In the US

- Madoff Case - the former SEC chairman, has admitted multiple failures on part of SEC in this case. No investigation was conducted into the promised “curiously steady” returns fund which only invested with Madoff. The SEC has been accused of missing numerous red flags and ignoring tips on Madoff's alleged fraud. Involved member of SEC married to Madoffs niece after scandal became public.
- According to former SEC employee and whistleblower Darcy Flynn, the agency routinely destroyed thousands of documents related to preliminary investigations of alleged crimes committed by Deutsche Bank, Goldman Sachs, Lehman Brothers, SAC Capital, and other financial companies involved in the Great Recession that the SEC was supposed to have been regulating. The tradition of destruction began as early as the 1990s.

However fraud continues…
Regulators, In the UK

- The Financial Services Authority **(FSA) ignored warning signals from Northern Rock building society** and continued to allow the bank to operate without a risk mitigation program for months before the bank's collapse
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Insider Trading

- Refers to trading on price sensitive information by company employees or individuals closely connected with the firm

- This information has not been disclosed to other market participants

Ethics & Insider Trading

- It violates equality of opportunity
- Does not give a level playing field between insiders and outsiders
- Might harm exchange as a whole because investors might not be willing to trade on exchange that does not give shareholders their rights.