

THE IMPORTANCE OF ETHICS IN BANKING¹

Business ethics are becoming more important in the financial world and are particularly relevant to banks, given the position of trust that they occupy. This speech discusses the importance of ethics in the banking industry and the role of the Hong Kong Monetary Authority (HKMA) in ethical matters.

I am pleased to have the opportunity to speak today at this important conference on business ethics. This is an area that is becoming a growth industry; and it is one that it is particularly relevant to banks given the position of trust that they occupy. Indeed, this is one of the daunting things about giving a speech about the importance of ethics in banking. It all seems too obvious. After all, what do we mean by ethics in business? It means, I would suggest, trying to be a good corporate citizen; trying as an organisation to adhere to certain ethical values; and trying to do the right thing by all the various stakeholders - customers, employees, suppliers and shareholders - that any business organisation has. It means, as one writer has put it, "choosing the good over the bad, the right over the wrong, the fair over the unfair".

Put this way, is there any respectable bank that would claim **not** to attach high importance to core ethical values such as honesty, integrity, fairness, responsible citizenship and accountability? Is there any bank that would claim that it was right to accept bribes in return for loans, to lend to connected parties and to cheat customers? Unfortunately, it is not as simple as this. If it were the case that business ethics simply represented values which everyone accepted **and** put into practice, this conference and my speech would both be superfluous. However, there is sometimes a gap between what banks claim and what they do. As the Asian crisis has demonstrated, ethical values are still not firmly entrenched and followed in many banks in the region. Bribery and corruption have been one of the root causes of the banking problems, and the Bank Bali scandal has shown that the process of reform still has a long way to go.

However, leaving aside such blatant examples of unethical behaviour, even the most well meaning of banks are going to confront moral dilemmas in the course of business. These dilemmas are more

complex than the simple: "should I lie, cheat or steal variety?" They pose difficult choices that have the potential to damage reputation and lead to financial losses. The problem is that in an increasingly complex business environment the choice is not always the simple one between what is right and wrong. It is more often between what is right and less right - in other words between shades of grey. This increases the need for organisations to adhere to a strong set of values to steer them through the minefield of ethical choices with which they are faced as they make business decisions. It is also necessary to ensure that the behaviour of the organisation is in practice aligned with these values and that employees buy into them, so that the organisation actually practises what it preaches.

Let me try to put some flesh on these arguments with some practical examples of ethical dilemmas involving banks that have been in the news recently. I have said that banking business is becoming more complex. One aspect of this is the globalisation of business activities, which may be summed up as the tendency of the world to become one market place. As banks reach out beyond their home market, they become exposed to unfamiliar business environments and customers whose ethical standards may be very different from their own. This puts extra strain on the "know your customer" policy upon which regulators are so insistent. Business dealings with Russia are a case in point. Here you have the situation of a country that is making the transition from a communist to a capitalist economy. This naturally creates profit opportunities for Western banks. It could indeed almost be argued that these banks have a moral responsibility to assist in transforming the Russian economy. Unfortunately, somewhere along the line, this transformation has gone wrong, and the borderline between what is legitimate and illegitimate business in Russia has become blurred, to say the least.

¹ This is the text of speech delivered by David Carse, Deputy Chief Executive of the Hong Kong Monetary Authority, at Banking Conference on Business Ethics Furama Hotel in Hong Kong on 15 September 1999.

In this situation, what should a bank do? The decision can obviously be viewed in strictly commercial terms. But there is an ethical dimension as well. Is it *right* for the bank to do business with Russian customers and to handle funds flowing out of Russia where it cannot be sure about the origin of the funds? No doubt many banks are asking themselves these questions, in the wake of the stories of huge amounts of Russian money being laundered through Bank of New York, and possibly other Western banks. Note that there is no suggestion at this stage that the banks actively participated in money laundering. Indeed, it is not yet clear if money laundering, as opposed to capital flight, is what was going on. However, difficult questions are going to be asked, not least by the US Congress, and the banks concerned are going to have to cope with the negative publicity.

Ethical dilemmas can also arise when banks try to innovate, particularly when they stray outside their home territory. Take an example from my own country, in the form of the Bank of Scotland's proposed joint venture in telephone banking with the American evangelist, Dr Pat Robertson. This was designed to enable the bank to expand abroad with the help of new technology and to attract US\$3 billion in deposits. On the face of it this appears to be a reasonable business decision, so where does the ethical dimension arise? The problem, as you may be aware, is that Dr Robertson is not simply a religious leader, he is also a right wing politician with controversial views on a variety of issues, including gay rights. News of the Bank of Scotland's proposed business link with such a person did not go down very well with gay activists or trade unionists in Scotland, or indeed with shareholders and the public generally. Matters were not helped when Dr Robertson was highly critical of moral values in Scotland. The bank was forced to pull out of the deal, to pay compensation to Dr Robertson and to issue a public apology in which it stressed its "long-standing commitment to ethical values". Despite the apology, the whole episode was widely regarded as a public relations disaster.

What lessons can be learned from this episode? The first, I suppose, is that banks need to be careful about business relationships with controversial politicians, whether of the right or left

wing variety. The second is the increasing power of the media and social pressure groups to throw the spotlight on what they regard as "unethical" business activities. In the case of banks, such activities might include financing the arms trade or industries that damage the environment. The third is the way in which ethical values change and how they can differ between societies: anti-gay attitudes are no doubt acceptable in the Mid-West of the United States, but they were clearly felt to violate modern notions of fairness, equality and non-discrimination in modern-day Scotland. The final point is how small the global market place has become and how events in one country can impinge on others. The chairman of the bank commented that they had not foreseen how the controversy surrounding Dr Robertson would cross the Atlantic to Scotland where he has no political constituency or business. This provoked the comment that the bank did not appreciate how new technology has shrunk the world.

The moral of the story is that banks need to consider how their actions - anywhere in the world - will affect their customers or be perceived by them. But customers are not the only people the banks have to worry about. They also need to take account of regulators in the various jurisdictions in which they operate, and the fact that regulatory standards may shift over time. The Credit Suisse Group has, for example, recently run into problems with the Japanese regulators because one of its subsidiaries in Japan was accused of engaging in window-dressing transactions with Japanese banks. These transactions are now deemed by the current regulators to be "inappropriate", though they were apparently not so regarded in the past. This illustrates that banks may encounter what has been termed "regulatory risk" not simply when they break the law. It also shows the problems they face in deciding which transactions are indeed "appropriate" where the rules of the game in the various markets in which they operate may not be clearly defined, or where the rules are shifting in line with changing standards of what is right or wrong.

The global reach of many businesses creates practical problems of control and of enforcement of compliance with regulatory and ethical standards, as the collapse of Barings Bank clearly showed. But

these issues also arise in domestic markets as the banks diversify into fee-related businesses such as the sale of insurance and investment management and advice. Leaving aside the possible risks from rogue fund managers, these activities can raise conflicts of interest and the issue of whether particular products are suitable for the needs of their customers. The classic case of how things can go wrong is the recent pension misselling scandal in the UK. Hundreds of thousands of employees were persuaded by pension salesmen and the companies they represented (including major banks and insurance companies) to switch from occupational pension schemes provided by their employers into personal plans provided by the companies. It turned out that in many cases, the employees were much worse off than if they had stayed in their original schemes. The banks and other pension providers stood accused of failing to give their customers suitable advice and sufficient information on the costs and benefits of making the switch. The end-result is that the offending companies have been “named and shamed” by the Government and pressurised into paying billions of pounds in compensation. The reputation of these firms, many of whom are household names in the UK, has suffered as a result. This comes at an awkward time when banks in the UK and elsewhere are attempting to expand their bancassurance activities and to persuade the public to trust them with their long-term savings.

Banks in Hong Kong will need to bear this lesson in mind as we embark upon the Mandatory Provident Fund Scheme. They will also have to be alive to the other types of ethical conflict that may arise as the banking environment becomes increasingly competitive and there is even more focus on the bottom line. The HKMA has already pointed out that as a result of interest rate deregulation that there will be both winners and losers among bank customers. Those with small balances and relatively large volume of transactions may find that increased fees outweigh the benefit of any increase in the interest paid on their deposits. As has happened elsewhere, banks may also become more selective in their choice of customers and the level of customer service may be affected if the number of branches is pruned to save costs.

A move towards a user pays approach and a reduction in cross-subsidisation are manifestations of the greater efficiency that deregulation is intended to produce. But banks will need to be careful that this process is handled with tact and sensitivity. Otherwise, they may be open to accusations from sections of the community that they are neglecting their social responsibility by curtailing, or increasing the cost of, basic banking services to the economically disadvantaged. This was certainly the accusation made against the Australian banks after deregulation there. A further aspect is that the possibility of higher and more extensive charges for banking services will make it all the more important for the banks to deliver sufficient information to their customers about these charges.

Let me clarify at this point the HKMA’s attitude to ethical matters and particularly the issue of “fairness” to customers. Our main responsibility under the Banking Ordinance is to promote the general stability and effective working of the banking system. In common with banking regulators in other countries, we interpret this to mean that our principal concern should be to determine that individual banks are financially sound and prudently managed. The aim is to reduce the risk of bank failure that would result in depositors losing money and threaten the stability of the banking system as a whole. We concentrate therefore on checking that the banks have adequate capital and liquidity and effective management and internal controls.

However, this is not all that we do. Section 7 of the Banking Ordinance goes on to say, among other things, that our functions include the following aspects that have a distinct “ethical” flavour:

- Taking reasonable steps to ensure that authorised institutions operate in a “responsible, honest and business-like manner”
- Promoting and encouraging “proper standards of conduct and sound and prudent business practices”
- Suppressing “illegal, dishonourable or improper practices”.

These specific functions can be related to our general function of promoting the stability of the banking sector. Clearly, if banks are involved in illegal or improper activities (such as fraud or money laundering) this may threaten the reputation not only of the bank concerned but also of the banking system as a whole. This in turn may lead to a loss of public confidence in the banks.

I believe however that our functions also imply a broader interest in the concept of “fairness” in the provision of banking services. This is not to say that the HKMA should act as a “consumer watchdog” in investigating and adjudicating on disputes between banks and their customers on matters such as the cost or quality of banking services. But at the same time we should not be indifferent to how banks treat their customers in general. If banks consistently provide a bad or unfair service, this may damage the reputation of the banks and destroy customer loyalty and confidence. Taken to extremes, the system as a whole could be brought into disrepute. This is why we promoted the Code of Banking Practice issued jointly in 1997 by the two industry Associations. The Code is intended to be observed by authorised institutions in dealing with their personal customers, and it provides an extremely useful mechanism for the promotion of fair and transparent banking services in Hong Kong.

What tools can banks use to manage ethics in their own organisations? No doubt you will have been discussing this during the course of the seminar and I will not go into a lot of detail in this speech. Clearly, the first essential is for the bank itself to be clear about the key ethical values to which it subscribes. It then needs to ensure that the organisation and the employees act in accordance with these values. This can be done through the adoption of codes of conduct. The former Commissioner of Banking issued a guideline in 1986 which requires all authorised institutions in Hong Kong to prepare a code of conduct for their staff setting out the standards to which they are expected to adhere. It is also necessary to have policies and procedures designed to ensure compliance with the standards specified in the code of conduct. For example, many companies now employ “ethics officers” and give their staff specific training and advice on ethical issues. The guideline

issued by the Commissioner of Banking recommends that all institutions should appoint at least one senior officer to handle queries from staff and other matters relating to the code of conduct.

Codes of conduct and the means to enforce them are important tools. But I would caution against too narrow a compliance-based approach towards ethics management. It appears from survey responses carried out in some US companies that the most important factor in controlling unethical conduct within companies is how staff perceive the value that senior management attaches to ethical behaviour. What matters in other words is the general culture of the organisation and the example that is set by those at the top. An important way in which behaviour of staff can be influenced is, for example, through remuneration policy, and senior management needs to be careful to ensure that rewards are not given to staff who uses dubious practices to gain business.

This brings me round to the role of the board of directors in banks. As you will recall, we commented in our recent Policy Response to the Banking Sector Consultancy Study on the need for high standards of corporate governance within the banking system as the environment becomes more competitive. We had in mind particularly the need to enhance systems of risk management, and we noted that the primary responsibility for ensuring this rested with the board of directors. We could equally make the same point in relation to the promotion of high ethical standards within banks. The board of directors has an important role to play in establishing the overall culture of an organisation. It is also the ultimate body for resolving the type of complex ethical dilemmas I referred to earlier, and ensuring in particular that the reputation risks in new business strategies or product are carefully addressed.

I hope that this conference, and my speech, have demonstrated that high ethical standards in banks are neither a luxury nor an abstract ideal. Rather, they are a vital aspect of protecting and enhancing the bank’s brand image, and ensuring its long-term business survival. Behaving ethically is not only the right thing for banks to do, it also makes sound business sense. ☯