On The Margin

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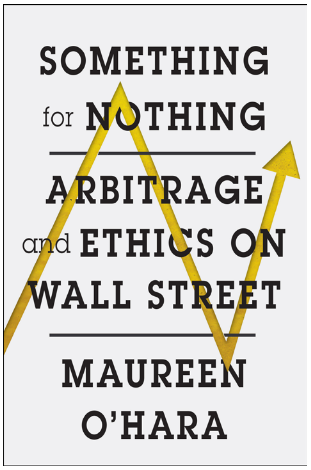
O'Hara Publishes Book on Ethics and Finance

In October, Norton Publishing Company published *Something for Nothing: Arbitrage and Ethics on Wall Street*, (Norton, 2016) a book on ethics and finance by CREDO board member Maureen O'Hara has published. The book is a major achievement for O'Hara, the Robert W. Purcell Professor of Finance at the Johnson School of Management at Cornell University, and is the culmination of three years of work. The book examines the ethical dimensions of arbitrage from multiple viewpoints and emphasizes both the need and difficulties in thinking about ethics in finance. Indeed, O'Hara examines how ethics applies to the complexities of modern finance by considering a variety of relevant real world examples.



O'Hara is a founding member of CREDO and one of the earliest participants of the Lumen Christi Institute conferences on economics and Catholic social thought. She credits the discussions there as having played a role in her decision to write the book. "It certainly made me think more about trying to integrate my work and my faith."

The book itself is written for a general audience, and was published by a mainstream publisher, a rarity for a book on ethics. Although it is not specifically Catholic and targets a broader audience, O'Hara explains, "I tried to bring Catholic doctrine to bear in sorting out ethical issues. I also tried to show that alternative ethical approaches reach similar conclusions, giving readers a perspective on the generality of Catholic ethical teaching."

This general audience approach appears to be having an impact. The book has received plenty of coverage in the popular press, including reviews by the *Atlantic Monthly* and the Italian newspaper, *la Repubblica*. *Business Week* listed it as one of five business books to read on a holiday vacation this year, "The SEC invited me to give a book talk to their employees," notes O'Hara.

Nonetheless, when asked whether she had advice for aspiring authors at the intersection of economics and ethics, O'Hara gives sobering words: "Have low expectations. Most publishers and agents are leery of ethics books. But writing it can be very enjoyable and you may even change a few minds about what constitutes ethical behavior in modern economies."

this issue

Update from the President of CREDO

CREDO has just finished our third year of formal existence this past summer, and this is our sixth issue of "On the Margin". It's been a successful three years, and the organization continues to grow, as do our conversations.

This fall I was invited to attend a conference on Christian Humanism in Berlin that Father Martin Schlag organized and the Ponticifcal University of Santa Croce sponsored. It was an exciting conference, headlined by by Nobel laureate Roger Myerson, who gave a talk on how decentralized government helps build state capacity and good governance by allowing aspiring politicians with career concerns the opportunity to prove themselves and establish reputations at lower levels of government. Joseph Zahra, who is the lay president of the new Pontifical Commission for Reference on the Economic-Administrative Structure of the Holy See (the commission leading the economic and bank reforms within the Vatican), gave an excellent summary of the process, advances, and issues facing the reforms.

From a conversation at this conference, the idea was sparked for CREDO to finally sponsor an event in Rome. This May we will take the mini-camp on Catholic social thought to Rome, and we will collaborate with Father Schlag and Father Bob Gahl of Santa Croce. Both are experts in Catholic social thought as it relates to business and economic ethics, and indeed Father Schlag is a consultant to the Pontifical Council for Justice and Peace. It should be an exciting week in Rome so look for the email announcing the times.

This spring will also be our first year without a Lumen Christi Institute conference, which we have decided to make an biannual event. On off years, we hope to supplement the program with an open invitation CREDO conference (or sessions at the ASSA meetings), but plans have not been finalized. If you have suggestions please contact us at contact@credo-economists.org.

As the front page article, shows this is also an exciting time as Maureen O'Hara's book represents perhaps the most tangible "output" of CREDO conversations, in the sense of a CREDO member engaging the broader discussion of economics and ethics in the mainstream media. (Certainly, other CREDO members have published academic works on the topic, e.g., Andy Yuengert's *Approximating Prudence*.) In honor of this publication, we have decided to dedicate this issue to the discussion of finance and ethics in the classroom and in the world. We have a number of interesting articles, including Martijn Cremers' contribution on corporate governance, Borja Larrain's article on teaching ethics in finance classes, and Jim Lothian's review of the 2008 global financial crisis and assessment of where Church leaders have gone wrong in their diagnosis and prescribed cure.

I hope you enjoy the issue. Please keep praying for Tim Fuerst, who continues his noble battle against cancer with an upbeat joy and grace despite his clear suffering both physically and emotionally. Last month, I was talking to an extremely senior professor in the profession who asked about Tim, and then said, "Tim is a saint". This professor was not Catholic but of Jewish heritage. When I went to give him an update, he interrupted to emphasize, "No. I mean Tim is REALLY a saint." I completely agreed, and he has been a tremendous witness throughout this ordeal. Please continue to pray for him through the intercession of Blessed Basile Moreau.

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"What Corporate Governance Can Learn from Catholic Social Teaching"

Martijn Cremers

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Since joining the finance department at the University of Notre Dame in the summer of 2012, I have been exploring the insights from the Catholic Social Teachings for business. I realized that I was pretty ignorant about Catholic Social Teaching, and that joining a Catholic University seemed a good occasion to start thinking more earnestly about the integration of my Catholic faith and my profession. I thus spent considerable time reading (and rereading…) social encyclicals written by the popes over the last 125 years, starting with *Rerum Novarum* (1891), then *Quadragesimo Anno* (1931), followed by *Mater et Magistra* (1961), *Populorem Progressio* (1967), *Laborem Exercens* (1981), *Sollicitudo Rei Socialis* (1987), and *Centesimus Annus* (1991), and ending with the recent *Caritas in Varitate* (2012) and *Laudato Si'* (2015).

I'd first encourage the reading of these social encyclicals (and more, as I've only listed those I read so far). When first reading these, I was struck by how well-written and well-argued (and thus accessible to anyone) these generally were. At the same time, it is also true that the content of many arguments challenged me and frequently confronted me with my limited theological and philosophical understanding, making me realize how much more studying I have to do.

My first purpose was to try to better understand what the truths of our faith – about the reality of the human person, human flourishing and development, social relationships and social justice, virtues and freedom, etc. – imply for financial economics. Secondarily, I've been trying to integrate teaching finance and Catholic Social Teaching in the elective class I teach to our undergraduates, most of whom are practicing Catholics. While I am still at the beginning of my exploration of Catholic Social Teaching, a good way to learn something is to teach it (though, indeed, alas for my poor students…). I'd be glad to share and exchange teaching materials with anyone who is interested. Broadly, my class consists of two parts. In the first, we mainly focus on understanding the Catholic Social Teachings as they pertain to business economics. In the second, we compare and contrast three views on the purpose of business, namely (i) shareholder wealth creation, (ii) advancing stakeholder interests, and (iii) contributing to human flourishing in the 'common good' of Catholic Social Teaching.

After teaching this class on corporate governance and Catholic Social Teaching for four years, I recently wrote an article summarizing what I have learned so far[1], and which I'm briefly summarizing here. My main conclusion is that agency theory (as exemplified by Jensen and Meckling, 1978) – the standard paradigm in most academic corporate governance research published today – is overly reductionist and can benefit from a more catholic – if not Catholic – perspective. In this standard paradigm (with a separation of ownership and control, incomplete contracting and where markets are assumed to be efficient, complete and competitive), the assumptions imply that maximizing the financial wealth of the shareholders is the optimal corporate purpose. The main inefficiency considered is managerial opportunism, to which ex-ante contractual incentives and exposure to ex-post market discipline are offered as the main tools generally available to mitigate this inefficiency.

Notwithstanding the many insights standard agency theory provides, I (now) think that it tends to insufficiently incorporate economic and human limitations. First, agency theory typically downplays three important economic limitations that distinguish firms from markets: asymmetric information, incomplete

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You are also called to serve: teaching ethics to finance students

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The other day one of my students said to me "arbitrage is immoral." He was repelled by what he saw as a zero-sum game where arbitrageurs profit from less informed investors. I tried to convince him of the benefits of price discovery, the fact that most arbitrageurs are managing other people's money and hence rendering a service to them, and so on. It was useless. My words caused no (noticeable) impact on him. I truly believe there is value in what we do in finance, basically moving savings towards the most productive enterprises. However, the profession has received a big reputational blow after the Lehman crisis; a blow from which we are yet to recover. Luigi Zingales, in his presidential address to the American Finance Association two years ago, crystalized this discontent and potential ways to address it.

Going back to arbitrage: is it truly immoral, as in incompatible with being a Catholic? The first thing that comes to mind is how our Lord used arbitrage and finance in his teachings. For instance, in the parable of the trader who finds the most beautiful of all pearls (certainly undervalued in the market) and sells everything he owns, perhaps even taking some leverage, to buy it (Matthew 13:45).

Or consider the parable of the talents, where one of the employees receiving a talent is reprimanded for not putting the money in the bank and getting at least the interest (Matthew 25:27). This seems to me like an early example of the opportunity cost of time! Our Lord certainly knew that He had many traders and bankers in the audience, and that He had to speak to them in their own terms.

If you look at the apostles, at least one of them had a finance background. Saint Matthew was, in modern parlance, an IRS official. And our Lord called him while he was working –collecting taxes (Matthew 9:9)—, as also depicted in the beautiful painting by Caravaggio.

Therefore, finance cannot be intrinsically bad. It is certainly full of temptations like all human activities. So, how to teach our students to resist those temptations and be "ethical"?

I see at least two ways of teaching ethics to finance students. Perhaps the way that is preferred by many is what I call the "cookbook" approach. This approach basically teaches rules and regulations, although this might be a cartoonish depiction. Do this and don't do that; don't step outside the boundaries of the law. Respecting the law is certainly necessary, but it often leaves students with little understanding of why we do what we do. At the end of the day it all typically boils down to two simple commandments: don't steal and don't lie. You can teach an entire ethics course with variations on these two principles, but it gets repetitive. Let me propose a second and complementary approach. I call it the "existential" approach. What I propose is stirring students consciences by letting them know that, wherever they are and whatever they are doing, the Lord is calling them. Like Saint Matthew at his tax collector's desk, modern finance people in trading desks, in the midst of all those Bloomberg terminals and spreadsheets, are called to serve and respect others. They are called to obey the rules, but above all they need to work hard for their clients, in particular the small ones, putting their interests first, while being loyal to competitors and other characters that populate the financial world (auditors, IT providers, etc.). They do not need to change what they are doing, as in leaving the finance industry because it is immoral, for instance to become priests or nuns (although that would be great too because we need more vocations). The Lord is calling them to do something much more radical: they need to change their hearts.

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Vatican Reactions to the Financial and Debt Crises

James R. Lothian

Close to ten years have now elapsed since the start of the U.S. financial crisis in summer 2007 and a full seven years since the start of the European debt crisis at the end of 2009. Scholarly studies of both began early on and in short order had identified the basic causes of the two. Vatican reactions came only a short time later, but paid little to no attention to the scholarly literature and as a result were wide of the mark in both their analyses and their policy recommendations.

One of the first of the scholarly studies was John Taylor's *Getting Off Track* which was published in early 2009 just as the worst of the U.S. crisis had passed. Taylor provided an excellent overview of what had gone on. With regard to the causes of the financial crisis, the book's subtitle said it all, "How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis." Here Taylor pointed to the crucial role of subprime mortgages, coupled with too expansive monetary policy in the early 2000s and inappropriate policies followed by both the Fed and the government as the crisis developed.

Anna J. Schwartz, who arguably knew more about financial crises than any other economist ever, in her blurb for the book wrote: "If Milton Friedman and I had written as persuasive an analysis as this, one year—rather than 30 years—after the Great Depression began, the United States might have had a typical recession rather than the greatest downturn in history."

I was editing the *Journal of International Money and Finance* (JIMF) at the time and in April 2009, two months after Taylor's book appeared, we co-sponsored a conference at Warwick University, "The Global Financial Crisis: Causes, Threats and Opportunities." The papers presented there and subsequently published in JIMF corroborated and otherwise complemented Taylor's analysis. The article by Gerald Dwyer and Paula Tkac stands out in this regard. Dwyer and Tkac, like Taylor, identify securitized subprime mortgages as the prime movers of the financial turmoil and trace their effects throughout the rest of the fixed income market.

In July 2009, Pope Benedict XVI issued his social encyclical *Caritas in Veritate*. Only a minor part of the encyclical dealt with the crisis, but the part that did was completely off kilter. There was no mention at all of the key roles played by the Fed and the U.S government prior to and during the crisis. Instead, it spoke of a need for "regulation of the financial sector, so as to safeguard weaker parties and discourage scandalous speculation, and experimentation with new forms of finance," in the process begging two questions – the economic function of speculation and the benefits or lack thereof of financial innovation. It went on to issue a call for a "world political authority" the functions of which would be "[t]o manage the global economy; to revive economies hit by the crisis; to avoid any deterioration of the present crisis and the greater imbalances that would result; to bring about integral and timely disarmament, food security and peace; to guarantee the protection of the environment and to regulate migration."1

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> The letter is a rather rambling mixture of casual empirical claims, confused economic theorizing and dubious moral theology.

Then in October 2011 the Pontifical Council for Justice and Peace weighed in, issuing its letter "Towards Reforming the International Financial and Monetary Systems in the Context of Global Public Authority." The letter has two principal concerns: the financial crisis and the

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Something for Nothing: Arbitrage and Ethics on Wall Street (WW Norton: NY, 2016)

Maureen O'Hara

The seemingly endless number of scandals at financial firms, combined with the perception that financial alchemy simply allows the already rich to steal from the unknowing, has fed a growing concern that modern finance is not good for society. From Occupy Wall Street to the Economist magazine, the question posed is whether the golden age of finance has turned into the failure of finance.

As a financial economist, I find such growing distrust disquieting. Equally disturbing is the view among some practitioners (and, for that matter, MBA students) that ethical issues are not relevant for finance; that the application of the arbitrage-based techniques of modern finance application is defined simply by whether it can be done, and not by whether it should be done. I decided to write this book to set out a broader view of finance: a view that explicitly recognized the intersection of arbitrage and ethics. I argue in the book that that while arbitrage-based techniques, done correctly, can lead to tremendous benefits at little or no cost (i.e. "something for nothing"), these same financial techniques can be used to exploit others, to take advantage of the complexity to behave unethically. The ability to arbitrage around rules and regulation can facilitate behavior that is at best dubious and at worst completely unethical.

But how to sort out the lines between what is and is not ethically acceptable? In the book, I set out a variety of approaches (religious, legal, philosophical and culture) to establishing these lines. As a Catholic, I believe the notion of "doing unto others" (Matthew 7:12) is fundamental, as is the view that both what you do, and what you do not do, are equally relevant. But, what I found intriguing was the commonality of views across religions. Islamic finance, for example, views virtually all financial transactions as having ethical dimensions. And, like the arbitrage–based *Contractus Trinus* that was used in medieval times to circumvent the Catholic Church's prohibition against paying interest on loans, modern Islamic finance also uses arbitrage techniques to expand the set of acceptable practices.

Part of the challenge of modern finance, however is that it is complex, and often the applications are new and unique, making it hard to see these moral dimensions in practice. I look at a variety of cases, including Goldman Sachs' use of financial engineering to help Greece enter the EU, Bank of America's handling of mortgage-backed securities, Lehman Brothers creative repo strategies, toxic loans in France, Goldman's machinations in the aluminum storage market, and strategies in high frequency trading, to discuss where these ethical boundaries arise. A case I find particularly on point is JPMorgan Energy Ventures exploits in the California electricity market.

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Facing an arcane and complex auction system for allocating electricity, JPMEV optimized by using a variety of strategies designed to induce compensatory payments rather than to actually produce electricity. The Federal Energy Regulatory Commission, after outlawing particular strategies only to have JPMEV develop new ones, charged JPMEV with manipulation, a charge JPMEV denied but settled by paying a fine of $410 million. As I discuss, the ethical limits of arbitrage may be difficult to discern, particularly if you are not cognizant that there are any.

Pope Benedict XVI wrote that "Financiers must rediscover the genuinely ethical foundations of their activity, so as not to abuse the sophisticated instruments which can serve to betray the interests of savers." I hope my book can facilitate this process, or at least begin more of a dialogue both in the classroom and in practice of the ethical dimension of modern finance.

contracts and markets and the need for coordination through power in corporate hierarchies (Rajan and Zingales, 1998). While corporations require explicit coordination towards a cooperative, shared purpose, markets can largely be led by 'the invisible hand' once embedded in an environment with transparent and enforced rules.

Second, standard agency theory takes personal preferences as given without acknowledging our common human frailty. Given our 'human brokenness', we often may not recognize what is good for us and others, we may not want what is good or substitute 'lower' for 'higher' goods even if we do, and finally, our actual behavior may not correspond to what we would want. These human limitations include what psychologists and economists call bounded rationality, opportunism and behaviorism (Williamson, 1998).

standard agency theory lacks sufficient appreciation of how firms as social organizations are different from competitive markets

The reductionism in standard agency theory has the following three implications.

First, it may prevent a consideration of what the purpose of business is (i.e., beyond creating financial value), what our responsibilities in business are (i.e., beyond honoring what's explicitly written in contracts), and how persons working in business can develop and grow their virtues and skills (i.e., beyond making that one's own individual responsibility). If preferences are taken as given, as individualistic or even relativistic, then these questions have little place in the discussion and could lead to the mistaken notion that the strong assumptions behind agency theory are 'morally neutral' (or devoid of ethical content). There is no morally neutral ground regarding the why, how and what of business, as business is done by, with and for people, and anything affecting actual human persons pertains to morality. The set of principles proposed by CST – human dignity, solidarity and subsidiarity – can serve to direct a rational discussion of purpose, responsibilities and virtue in business.

Second, by downplaying the economic limitations (of asymmetric information, incomplete contracts and the need for coordination), financial economists risk missing the inherently social or cooperative nature of value creation in firms, where multiple stakeholders have to commit to working together towards a common goal. Indeed, as standard agency theory lacks sufficient appreciation of how firms as social organizations are different from competitive markets, it tends to neglect what is arguably the main problem impeding the creation of value, namely how to coordinate – through the use of power – the activities of many different stakeholders who in cooperation contribute to the creation of corporate value (Williamson, 1998; Mayer, 2013; and Johnson, Karpoff, and Yi, 2014).

Third and finally, I argue that agency theory may facilitate a rationalization and justification of unethical behavior. If shareholders, directors and corporate managers see themselves as 'only' participants in fully competitive markets where all of the other participants are (or should be, as they are presumed to have opportunity to be) fully informed with effectively complete contracts, they may reasonably think that any legally-sanctioned action is also morally legitimate. Similarly, the more people think that they are engaged in a 'morally neutral' activity, or assume that how we treat others is purely relativistic, the more they may be susceptible to misusing their power. In situations with more asymmetric information, incomplete contract/markets and limited competition, those who have superior information, power and control have more opportunity to abuse their information, power and control at the expense of others, particularly those with the least information, power and control.

In the remainder of the paper, I consider what insights Catholic Social Teaching (CST) can provide to overcome these limitations, but for that, I refer you to the paper. If you are interested in discussing these issues, please contact me at mcremers@nd.edu.

1 See the article titled "What Corporate Governance Can Learn From Catholic Social Teaching", forthcoming in the Journal of Business Ethics, available here: http://rdcu.be/mRHS

Lorrain Continued

Perhaps the financial sector is an example of what Pope Francis calls the "existential outskirts" of society. These are parts of society where God is apparently absent, but that doesn't mean that God despises people who live or work there, or who face those situations. It doesn't mean either than Catholics have to stay away from those places, quite the contrary. Good men and women, who are aware of their call to serve in all human endeavors, are necessary to conquer those existential outskirts. Our students have to be those good men and women.

Lothian Continued

distribution of income internationally. Rather curiously it makes no mention of the European debt crisis which was by then well underway.

The letter is a rather rambling mixture of casual empirical claims, confused economic theorizing and dubious moral theology. Consider the following passage as an example:

> In monetary and financial markets, however, the dynamics are quite different [from those in goods markets]. In recent decades, it was the banks that extended credit, which generated money, which in turn sought a further expansion of credit. In this way, the economic system was driven towards an inflationary spiral that inevitably encountered a limit in the risk that credit institutions could accept. They faced the ultimate danger of bankruptcy, with negative consequences for the entire economic and financial system.

In its discussion of the financial crisis, the letter is all over the place. Initially the letter alludes to the crisis having multiple causes. In a later discussion, it describes "money and credit instruments worldwide [that] have grown more rapidly than the accumulation of wealth" as a cause of crises in general. It finally gets to the bottom line with its assertion that "[t]he speculative bubble in real estate and the recent financial crisis have the very same origin in the excessive amount of money and the plethora of financial instruments globally." What exactly this means is, however, open to conjecture.

The letter follows up on "Caritas in Veritate" with its own call for a world political body, dubbed in rather Orwellian fashion "the Authority." What makes this proposal particularly incongruous is the harmful role that government policies played in the financial crisis and in the European debt crisis that followed.

More generally there is the question of whether a policy body of such scope that had control of both monetary policy and economic policy in the broader context would have any chance at all of increasing societal welfare. History certainly is not kind to the idea and neither is theory. Friedrich Hayek in his classic "The Use of Knowledge in Society" (1945) seven decades ago explained why planned economies would fail and the experience of both the last century and this one so far have borne him out. Why these messages have not got through to the Vatican is very hard to fathom.

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