



EVENT REPORT:

“Adam Smith’s Lost Legacy: Ethics in Financial Regulation”

Friday October 23

Attendees: approximately 65

Webcast Participants: 30

Professor Charles Sampford, Director of the Institute for Ethics, Governance and Law (a joint initiative of the UNU and Griffith University, Australia) has given insight into the **role of ethics in systematic economic governance and financial regulation reforms**.

The global financial crisis has been the result of multiple and reinforcing governance failures, where financial intermediaries abused the powers entrusted to them. Marking the 250th Anniversary of Adam Smith's "*The Theory of Moral Sentiments*" publication Professor Sampford started by recalling the importance of a "*values-based governance*" approach as part of Smith's lost legacy. The major current problems and possible solutions concerning the transparency and integrity of the financial system were discussed.

In 1961 anti-capitalistic barricades were set-up in East Germany by a government who later failed to prevent the wall's dismantling in 1989. The 2008 global economic and financial crisis seems to represent a turning point from the ideology of the past 25 years, which postulated the superiority of markets over democracy. **Capitalism can still play a vital role within a larger ethical order of values which will help to** avoid the radical change which took place in the ex-communist countries while trying to get over decades of planned economy, namely suffering a 50% decline in their GDP in the early 90s.

Unfortunately, the Financial System has followed a unpredictable path and the reaction of public opinion in 2009 has been strong wondering what role markets will have in future.

According to Prof. Sampford, the answer will come primarily from the South and the East, even though the problems we are addressing emerged in the West at the very heart of capitalism. A stronger ethical order will have to emerge to save the markets, following the example of the 1930s when the **American Social Democrats**



'saved' the world and financial markets through better regulation. This approach subjected financial institutions to certain requirements, restrictions and guidelines, aiming to maintain the integrity of the financial system. After 25 years of an aggressive wave of deregulation-, it is clear that basic, lessons need to be re-learned by the work force of the financial sector:

- Honesty and integrity in financial transactions do matter – they promote trust
- Providing information that is complete, fair and accurate wherever this is expected helps to preserve the integrity of the system. The converse undermines it
- Boards should not allow the erosion of due diligence over time – the costs are too high
- Regulation via effective monitoring needs to become an integral part of the system Enforcement is equally important. A more effective system of ethical safeguards or checks and balances has to be developed – preferably automated to some extent so that personal judgment clouded by personal interest does not limit transparency.

Finding a compromise is challenging because of a long standing concern that **capitalism without democracy would not be sustainable**. The issue of trust has come to the forefront once again with the current sub-prime mortgage and financial sector crisis. The crisis has been fueled by a breakdown of trust caused by the inclusion of mis-priced mortgage risk in structured products. When claims on sub-prime mortgages were turned into assets for investors to buy, the risk in these sub-prime mortgages was not properly priced within the asset. The incorrect valuation of the asset was thus carried from the mortgage lending sector into structured products in the financial sector which were then inappropriately rated as AAA assets in many cases, based on the erroneous assessment that these assets were characterized as low-risk. Thus a multitude of new investment vehicles and assets that embodied a breach of trust was created. These assets were bought by financial institutions and by people all over the world.

Since the risk in claims on these assets had been mispriced, the defaults had the effect of revealing this breach of trust.

The popularity of capitalism that existed beginning in the 1980s has severely decreased since the recent financial and global economic crisis. We should recognize the dynamic power of markets, which allow us to



trade what we have for what we would prefer, but also recognize that capitalism has gone too far, being the main reason of a global disaster, and this is true globally as much as nationally.

Self-interest is a very important motivation but it is not enough. The logic behind market trading is still very important, but this is only one element in an effective order that serves the interests of the community. It is clear that Adam Smith's "*Theory of Moral Sentiments*" has a lot to do with economics.¹ His lost legacy reminds us that beyond self-interest there are other **critical missing variables**.²

Ethics is central in society. The social sciences need to work together, especially the disciplines of ethics and economics, to support each other. During the 18th Century Economics, Philosophy, Law, and Ethics were all studied together before the modern separation. Economic actors, societal and social actors and institutions are all related. Today, we have very strong and effective disciplines over-theorized. We do not have to go simply back to Adam Smith's approach, but rather we need to apply his lessons related to ethical universal values, which need to be balanced with private interests and the rise of institutions and economic values.

Coordinating more individuals and their private interests tends to get higher results, as NGOs and Civil Unions can attest to. As far as Governments are concerned, the main issue is how they can ensure services to citizen through good governance without abusing entrusted powers. Lawyers are fundamental because they take care of formal rules and fix problems. Political scientists study the power structure and economists are concerned with positive and negative incentives. Crossing these disciplinary boundaries is part of the solution to the financial crisis. Coming back to Adam Smith's theoretical framework, there is a problem of **radiology**, since bad examples come from the ideology of the problem. Weaknesses can be found on all levels, from global governance, regional and national governance, to corporate governance. The global financial and economic crisis was a prime example of this, and therefore we need to recognize the role of all institutions, looking at the insights of every discipline. Smith, like Bentham, would have seen little point in separating the modern disciplines of law, ethics, politics, and economics.

The rules involving institutions and organizations are more complicated than the ones concerning single individuals. The main goal of governance is to apply the most effective rules of institutions and organizations. This process is both top-down and bottom-up, therefore it is important to consider the roles of actors involved at all levels of governance.

¹ A. Smith, "Theory of Moral Sentiments", oxford, Oxford University Press, 1976

² Adam Smith's Dinner, previous speech of Prof. Sampford



Going back to Adam Smith's time, a huge change which took place was the rise of **institutions**, which have to be insured to live up to their promises, since corruption and lack of transparency are all problems related to the abuse of entrusted powers. We do not have to get rid of institutions but rather make them stronger and more reliable and the issue is especially pressing after the current economic crisis which furnished a vivid example of system-wide failure.

In order to resolve this financial crisis, we need to use a multidisciplinary approach, revitalizing the concept of trust and 'fiduciary' duty. *"The reality of global capital flows and the nature of the problems involved means that the search for an equitable and sustainable solution cannot be undertaken by one nation using the conceptual frameworks privileged by one disciplinary perspective... What is required is a reform and effective global financial integrity system."*³ We need to address the integrity of the global financial system.

Report written by Renato Giacon

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³ Adam Smith's Dinner, previous speech of Prof. Sampford