Preemption and social codes in the financial industry

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Abstract

Yuval Millo is Professor of Social Studies of Finance at the University of Leicester (he was a lecturer in accounting at the London School of Economics until September 2012). In his work and publications, he focuses mostly on the sociology of financial markets, in particular on the study of social networks, technology and governance in the financial services industry. In this conversation Annalivia Lacoste asks Yuval Millo about his views on transparency in the financial sector, responsible innovation and the evolution of the social codes of finance professionals.

AL (Annalivia Lacoste): Discussion on responsibility and irresponsibility in the financial services industry often focus on traders and their behavior. But you claim that focus on other types of actors, such as brokers and other intermediate actors, should be beneficial to understand - and to foster - responsibility in finance.

YM (Yuval Millo): You can find different people with various perceptions and ideas of responsibility in the financial sector. Some of these people are part of organizations that have some kind of intermediate role to play, and who organize the exchanges. Let's take the example of brokers. Brokers occupy a crucial position because, in a sense, they aim at maintaining what I would define as some sort of "social hygiene" inside the sector.

AL: What do you mean by that? Do brokers care for "clean" transactions?

YM: If I were a broker, and if you would run a hedge fund, obviously you wouldn't want to be part of something that might be seen as immoral or illegal, and you would rely on me to guarantee that. But we have to remember that the fact that some investors are more entitled now to think about responsibility and to develop detailed plans to implement it doesn't necessarily mean that they are more or less moral than before. They could be just as committed to ruthless, utility maximization as their colleagues, but in the actual context, getting involved in responsible innovation is good for business, and is a protection. Their definition of being responsible, though, is usually taken from the domain of corporate social responsibility - and means that you can do well by doing good.

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AL: So you say that the important element is reputation risk, and that intermediate actors, such as brokers, can comfort a guarantee in that direction. This quite resonates with the phenomenon of greenwashing, with green marketing being used more as an insurance against reputational risk than as a real commitment to the mitigation of environmental externalities.

YM: Yes. The same process exists in the financial sector, and is very interesting because it deals with the paradox of demanding. If you were a regulator, the Financial Services Authority in the UK or the Autorité des Marchés Financiers in France, you would ask your banks to include an element of corporate social responsibility in your financial products. That way you would create a situation whereby that greenwashing is introduced by you, because you are the entity that creates this loop, in ordering a measure of the "responsible performance" of the company. But this process can be useful and a positive thing. By giving instructions or directives in the sense of responsibility, you can get many results. This demonstrates how people react to different forms of incentives.

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AL: New incentives for more ethical and responsible behavior in the finance industry have emerged quite recently: the financial sector has always had rules and codes of its own and is more a risk-based system than a responsibility-based construction. Ethical issues and moral values today are at the core of some finance-related activities such as microfinance, corporate social responsibility and socially responsible investment, but weren't top-priority issues in investment banking in the past. What do you think about this recent public awareness for the promotion of responsibility in financial markets and investment banks?

YM: I would rephrase your question, simply asking what kind of events and situations have led us to ask it. The real issue is why we formerly believed that finance and responsibility couldn't match together. Let's take the example of investment bankers. I wouldn't say they are worse than you or me. As a banker, if I'm giving you a loan, a mortgage that you will pay in the next 20 years, I need to be sure that you will be a good borrower, and that I can rely on you. This means a strict verification of your documents, of your job situation, checking you have a permanent job or not and what kind of contract you have, and, of course, a check-up of your wages as a guarantee, and your expenses per month. In terms of financial health, I need to be left with a liability and to make sure that if I'm selling your mortgage as 20 years of cash flows to someone else, you can pay me and I will get some benefits. Let's generalize from this: if we have a market where we can easily commodify liabilities, then it actually creates an incentive, without creating responsibility. When I'm giving you a loan, I'm actually taking on your liability. The easier it is in a certain society to create markets, where liabilities are standardized, the easier it will be for actors to be responsible. In the market field, the liability is the only test of responsibility, which doesn't rely on the internal qualities of the actors and on their own virtue. As a trader, I am in a situation where I can ”offload-onload” liabilities as much as I want, and it makes it easier for me to be irresponsible or responsible. Chains of risks are created not only because of people's behaviors, but also because of the conditions in which liabilities are created (or artificially created).

AL: So the emphasis has to be put on the market environment to promote responsibility, not only on the actors?

YM: I won't go all the way, since the responsibility of organizations is also crucial in this system: they define their own way to commodify things very easily, to standardize them, and to introduce them in the markets. The market is a structure with inherent risk-based dynamics. If an open market for the procurement of kidneys or other organs existed, buyers and sellers would certainly take all the medical risks, simply because they would obey to a market logic, let alone the rest. There is such an acceptance for markets nowadays, and for this logic, that the simple fact (actually, not so simple!) of giving something to someone, without asking for anything else in exchange, has become unusual, even surprising! But if you say you will sell this thing, you place the sale action in a context that makes it easier for me to accept. In fact, the market becomes a kind of platform that makes things more acceptable in a way, because we are so unused to think about things in terms of exchanges, that we need a justification, a scene where to proceed to these exchanges. Of course, there's a whole sociology of gifts: there's an exchange in the gift and a gift in the exchange, but just think about what a strong and legitimate device a market is, and how deeply ingrained the notion of transaction is. Given that, if you analyze all things in terms of a market, it helps understanding how the concept is strongly rooted in our societies. The market system is not just an outcome in terms of trade between people, but above all because people get immediately connected through the notion of exchange, and you need very strong arguments to destroy it. For example, it is not very moral for people to sell their organs, neither it is to sell drugs, both activities have a very bad social impact. But you need to have very strong arguments against the creation of a market since this concept of exchange has become so dominant, and is now a template for social interactions. I think that this system of markets and exchange creates its own normality; it allows you to be easily irresponsible. After having studied this chain of arguments, and the background concepts, it helps understanding how people in finance in the last five years spent a lot of their time standardizing markets for liabilities, and how they managed to build a very nice tower of assumptions.

AL: If you focus on liabilities, it means that you focus on pending relations between actors. Is that the crux of your analysis on the construction of responsible or irresponsible markets?

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YM: For me, if a good market allows you to be responsible, it means it gives you a good closure and that it doesn't leave a lot of ties between the buyer and the seller. Maybe we should then focus on how to artificially maintain a full complete efficient closure. Creating new forms of guarantee for the payments and the complete transparency and security of the exchanges are the key solutions, since the risks are often associated with people defaulting.

AL: Aren't these guarantees difficult to implement, especially when people think in terms of costs and efficiency?

YM: Back in the early 1960s, there weren't any cars with seat belts. Do you know how they came about? At that time, for the car manufacturers, it was costly: even though more people were dying or could get killed, car manufacturers wouldn't put seat belts voluntarily. Before it became a regulatory demand, only very specific cars had seat belts, it was an extra. The companies would say it would increase the costs, make cars more expensive, and that the construction process would be more difficult. The necessity for safety and security wasn't a top priority issue for the industry.

AL: In the financial sector, the idea of regulation as a matter of urgency and the implementation of new incentives came after a huge systemic crisis. Do all industries always obey the same logic? Do we have to always wait for a general disaster to anticipate and regulate?

YM: Before studying financial risks, I was involved in the study of the protection from terrorist risks. There are many rules and regulations in this sector but, generally speaking, people are very bad at preventing. There is a whole set of regulations in order to make you understand how serious the threat is, but very often, the regulation itself is written in blood, and unforeseen attacks happen. I think we tend to be more reactive than preventive. You cannot always think about the next thing modernization will throw at you, and that is why we are more focused on the instant and the reaction. People react, and don't always preempt about things. Sometimes preemption can also be considered as a tiring process.

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AL: What do you think of the preemptive role of financial regulators?

YM: I don't think these agencies succeed in being preemptive, because they operate according to two orders of worth. If you are, say, the Financial Services Authority, you need first to regulate financial players and to report to political authorities. You need to translate actions and ideas from one area to another, and are facing the traditional "getting money versus getting influence" dilemma. Politicians need to react because the world is accelerating. The International Monetary Fund has to be reactive, so have the markets.

So if you are a regulator and you are working with partners obsessed with reactivity, you are not always ready to preempt. It is the whole system who pushes you to be reactive, at the political scale, and always because markets, by their very nature, tend to be information-driven; it is therefore not surprising that the regulatory system might not be entitled to think in advance.

AL: Is it necessary to impose a culture of preemption instead of a culture of reactive regulation? And, if so, how?

YM: Imposing a culture and its normality is a very difficult job. Maybe you know this joke with an economist, a physicist and an engineer who are stuck on a desert island, they have no food and are starving; a ship comes to the island and it has a lot of cans on it filled with tuna. The question is how they can open the cans: the physicist says the cans are made of litter, so he can try to open it with the help of the sun reflection, the engineer looks at a tree and says if he cuts the tree it might fall on the can and break it; and the economist starts his statement saying: "assuming that we have a can opener, we could try to do it". This joke's conclusion's reveals also the huge change in mentalities imposing a culture of responsibility represents: assuming there is a culture of preemption, we could change things... In my opinion, there's a need for mutual understanding for both parts, the financial actors and the regulators. As soon as you open a market, sooner or later you will have to meet a regulator at some point. So each other has to understand the other's codes. But the issue remains: how do you internalize norms of preemptiveness, and of responsibility?

AL: Yes, exactly. The question is how to internalize these norms, these codes of conducts. I guess this is a sociological question, right? What about incentives?

YM: Sometimes incentives are lined up in such a way that systemic stability and progress are being achieved, sometimes not. There are in fact many proposals about how to it. Traders' bonuses could be paid with a delay, and not only if the company has done well, but also if the customers services have been successfully achieved, and if the entire market is doing well and is safe. I don't think things are static: people can act in a very pragmatic way if you give them the right conditions, and prove that, as an investment bank CEO for example, you can be able to encourage more responsibility. You will, of course, still attract people already working in the system; but I'm convinced that behaving more responsibly actors of the financial industry could also do a process of selection of the people attracted not by the instant profit and quick money, as it was predominant before the crisis. The markets I studied, the trading markets, were supposed to make money quickly but I noticed traders were also very bad at keeping their money, as the old say "easy come easy go". They hired specific people to do the clearing mission for them. These people were there to ensure

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traders could respect their future commitments. The clearing professionals who I spoke to were delivering advice to the traders about the kind of investments they could make, and this started in the mid-70s. Traders weren't their bosses and didn't have any authority or influence on them, they were totally independent.

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AL: So clearers performed in the past as a sort of a moral authority on markets. What kind of role do clearers play now?

YM: These people started their professional career as traders and then moved on to become the people handling the traders' accounts. Their example proves you can impulse responsibility with inducing schemes, not formal, but informal schemes. I guess they don't play an important part anymore now that everything is done on screens, whereas they had succeeded in bringing about a "face-to-face" dialogue with the traders at the time. Those small clearing firms have been bought by big companies such as Merrill Lynch, and the new clearing structures are now dealing with thousands people. There's no human-based professional relationships anymore in the sector; now all the social interactions, and the respect inherent to professional relationships, the recognition of the boss, the professional authority have disappeared almost entirely.

AL: What has been the impact of this rampant standardization?

YM: My colleague Daniel Beunza and I studied what happened on the markets when these moral agents disappeared. Markets became in fact more opportunists, and more volatile for two reasons. The first reason is because it has become easier to trade, and quicker: there are no informal "give and take" relationships anymore. If I trade in front of my computer, and it is all anonymous, then I don't care because I know that the other part I'm dealing with doesn't know me. This means people can be very ruthless, and that it became a real competition.

AL: The issue of transparency is also at stake: you can retain crucial information and hide things in the absence of a face-to-face relationship.

YM: This is very interesting since the arguments of the people who pushed for standardization and computers was to promote more transparency; they would say the commitments had evolved, and that it consisted in replacing one form of transparency with another one. The new situation can be compared to the example of a party you go where there is a room that is half dark: you cannot get to see all the people in the room, it is blurred and there is partial disclosure. So the notion of transparency with technology is challenged and it touches a point of responsibility. The conditions that allow us to be responsible or irresponsible are not based only on human relations but also on the machines, the tools and the devices we have. They play a key role in the process.