Unleashing the Transformative Power of Ethics in Finance

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It is an enormous pleasure and a huge honor to be with you this morning. I would like to express my deep appreciation to the Ukleja Center for Ethical Leadership, to Dean Michael Solt, and to the Long Beach Chamber of Commerce.

I am extremely thankful for the invitation, and for having this opportunity to have a conversation with you on a very important topic. In an attempt to get our conversation going, I would like to share with you some thoughts on living ethics every day in the financial service industry – and, more specifically, how to better unleash the transformative power of ethics in finance. I will approach this issue from the perspective of someone who came to the industry relatively late in life and through a rather non-conventional route.

Rather than apply for an MBA program after my undergraduate degree, I opted for a PhD program in economics; and rather than enter the financial services industry after completing this program, I joined the International Monetary Fund in Washington as an international civil servant, where I spent almost 15 years. Indeed, it wasn’t until I was about to turn 40 that I decided that the time had come for me to experience the private sector – and do so before too much of my human capital had totally dissipated with age!

In January 1998, I joined Salomon Smith Barney in London as an economist. It was quite an experience coming from a multilateral organization. Constituting essentially a “cost center” at Solomon rather than a group of direct revenue generators, economists were located quite far down on the importance ladder. And I was reminded of that in my very first meeting with my day-to-day bosses – traders in their mid-20s.
I must admit that, initially, it was quite a shock for someone who had spent so many years in a rather hierarchical organization. Fortunately, I adjusted and interacted well with my talented colleagues, learning a tremendous amount on how markets actually work – both during the good times and during the bad times.

This first direct dive into private finance at Solomon in London provided me with the wonderful opportunity to join PIMCO here in southern California in April 1999. Having had a terrific time interacting with the best of the best in the investment management industry, I am stepping down in mid-March. I will miss working with my talented PIMCO colleagues and friends.

My move from the public to the private sector 16 years ago was motivated by more than a desire to experience first-hand life in the private sector. I was particularly intrigued by the interaction of Wall Street with things that really matter for Main Street – jobs, opportunities for improvement, inequalities, and enhancing the welfare of current and future generations.

Remember, economic textbooks were quite clear about the role of modern finance in a market-based economy. Simply put, it is the best way to allocate scarce resources to the most productive uses, thus promoting investment in plant and equipment, improving productivity, creating jobs and raising incomes. When applied in practice, however, I have observed “conventional wisdom” fluctuate wildly between two quite opposing extremes during my time in the industry.

In the early and especially mid-2000s, finance was viewed as more than just the best allocator of scarce resources. It was also deemed to have the ability to self-regulate and self-correct as needed. And it was seen as an important contributor to the “great moderation” and to “Goldilocks” economic conditions.

By 2008, however, this view was discredited in favor of one that characterized unfettered finance as disruptive to general welfare. And for good reasons.

The 2008 global crisis, which originated in finance (structured finance to be exact), caused massive job and income destruction all over the world. It almost triggered what economists call a “sudden stop” that would have undoubtedly pushed the world into a multi-year great depression.

Most agree that poor ethics (in banks in particular) were contributors to the 2008 global financial crisis. And by poor ethics I mean behaviors that place the narrow self-interest of the individual well ahead of that of the collective (if not in conflict with it), and that result in individual actions that are inconsistent with the welfare of the whole, be it the company, shareholders or society at large.

As research has demonstrated, in the run-up to the financial crisis certain banks ended up selling financial services with grossly inadequate disclosures and without proper regards to suitability. In some cases, bankers themselves lacked sufficient understanding of the products that they were selling. What they seemed to know well, however, was that lots of fees were being generated.
Such behaviors typically place immediate gratification ahead of sustainability; and they favor short-term profitability rather than what is right over the longer-term.

There are many scientific and behavioral finance studies that explain why banks are vulnerable to poor ethics. Rather than repeat these findings, allow me to take a different course – that of “casual empiricism” – that is, share with you some thoughts based on my observations. In doing so, I hope to touch on issues that are actionable in the context of a comprehensive multi-year effort to live better ethics every day.

It is striking the degree to which the threat of finance lapsing into poor ethical outcomes is heightened by five factors that companies can influence directly:

- badly-designed incentive systems,
- outmoded institutional structures,
- inadequate leadership,
- limited cognitive diversity, and
- insufficient corporate citizenship.

As a standalone, each of these is damaging to the individual and the firm. Together they can pose major systemic risks for society.

If I may, please allow me to make a few very brief remarks on each.

It is hard to deny the power of financial incentives, especially on young traders starting their banking careers on Wall Street. And it is not just an issue of the money involved; it is also about how certain compensation systems can, in themselves, create perverse incentives.

On the urging of regulators, shareholders and the general public, we have seen in recent years major attempts on the part of banks to improve compensation systems focusing on: making options and other performance-related awards a larger part of the total compensation package; bigger deferrals of cash bonuses; and greater use of clawbacks which link subsequent cash disbursements to sustain good long-term performance.

The use of all three is increasing and, while still not yet at a critical mass, we should expect this to have a growing impact on behaviors.

Less well understood, however, is the disruptive role of outmoded structures. Even today, quite a few firms still maintain organizational structures that restrict transparency and undermine cross fertilization. As a result, too few eyes are looking out for the collective interest; and the potentially-constructive role of corrective peer review is weakened.

Needless to say, this speaks to the critical issue of corporate leadership. I suspect that there are still some leaders who don’t fully realize the extent to which others look to them for behavioral standards.
On ethics more than anything else, corporate leaders must, and are able to lead by example. By repeatedly putting the interest of clients and shareholders before themselves, and by establishing and adhering strictly to a transparent and well-designed code of ethics, these leaders set the tone every day. And to do so well and on a consistent basis, they themselves must be open to feedback in a culture that values open communication, frank exchanges and timely course corrections as needed.

This is another area where cognitive diversity helps a great deal. Indeed, it is a further illustration of why well-designed Inclusion and Diversity programs contribute so much to successful meritocracies.

Research has repeatedly demonstrated that diversity of people, mindset and thought processes is an important contributor to better outcomes, as are continuous efforts to maintain a level playing field by empowering and mentoring colleagues. Moreover, several studies have suggested that the probability of the 2008 global financial crisis would have been less severe had Wall Street had greater diversity, particularly at the senior levels.

This is not about words and fancy intranet sites, a trap that many companies have inadvertently fallen into. It involves careful and detailed design, thoughtful implementation, continuous monitoring, and constructive evolution.

Finally, there is the issue of corporate citizenship. I cannot say enough about how corporate volunteerism contributes to promoting better ethics at the workplace, and I am so delighted to see Sarah Middleton in the audience – a PIMCO colleague who has been incredibly transformational for us in this area.

Corporate citizenship events bring colleagues together in the context of giving back to communities. They help overcome barriers to communication in a manner than no formal corporate program can. And they vividly remind everyone that “wealth” and “wellbeing” are about a lot more than dollars and cents; it is also about ethics, integrity and giving back.

So here is some really encouraging news about these five factors. They are “endogenous.” By that I mean that they are all under the control of companies and their leaders, and they can be transformational in ensuring that the finance pendulum spends a lot more time serving society than undermining it.

There is another bit of good news. Awareness has increased substantially among a growing number of financial institutions, as well as the corporate world more generally. Intensified public scrutiny, better regulation and sounder supervision are important contributors in this regard, as is pressure from within. Multilateral initiatives also help, such as the United Nations-backed principles for Responsible Investment.
Some companies have evolved – though just for now to saying the right things. Many more have also revised and strengthened their code of ethics. Encouragingly, yet others have progressed with detailed initiatives to materially increase awareness at every level and to modify behaviors. It is this last group of companies that will likely do better as the global economy advances towards what we have characterized as a potential “T junction” (or “Y”) down the road.

Let me please conclude by explaining what is implied here (and has been analyzed in more details elsewhere).

Since the global financial crisis, the world has purchased tranquility through large-scale experimental use of public balance sheets (especially of central banks). While this has resulted in a long list of interventions with technical names, the basic idea has been a simple one: to temporarily use public balance sheets presses to replace damaged private sector ones; and to do so until the latter heal while other policymakers implement reforms aimed at strengthening growth and employment engines.

Very few people, if any, envisaged the scale, scope and duration of the experiments that have materialized since 2008. At the same time, most have been disappointed at the relative muted outcome in terms of growth and jobs – both in absolute terms and relative to their expectations.

In other words, it is taking the private sector quite a long time to heal. This has forced central banks, in particular, to remain engaged despite their rather blunt and imperfect instruments, and their engagement has been further prolonged by how polarized politics inhibits the ability of other government entities to step up to their policy responsibilities.

This situation cannot continue forever, especially given the threat of collateral damage from the experimental policy approach, or what former Chairman Bernanke called back in August 2010 “costs and risk.” At some stage, it will either yield to “escape velocity” for the private sector or, alternatively, to a relapse into low growth and renewed risk of financial instability.

Resilience and agility will be important contributors to companies’ ability to navigate this potential bimodal outcome. However, these are hard to maintain in institutions that place insufficient emphasis on ethics every day.

In closing, allow me to thank again the Ukleja Center and the Long Beach Chamber of Commerce for the opportunity to be with you today. As you continue your deliberations this morning, please consider the way in which we can all enhance the transformative power of ethics, building on the progress made to date.

Undoubtedly it takes time. It requires work, every day. And there are no short cuts or guaranteed solutions. Yet the benefits of getting it right are material and consequential – in terms of the impact on individuals, on companies, and on society as a whole.

Thank you very much.
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