

Alternative Ethical Perspectives on the Financial Crisis: Lessons for Economists

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Abstract

This paper analyzes the financial crisis from three ethical perspectives. It starts from utilitarianism, the ethical theory underlying neoclassical economics, which has partly driven the crisis. The best-known alternative is deontology, a rule-based ethics. This has failed to prevent the crisis because the dominant utilitarianism has undermined professionals' belief in universal rules. The third approach is the ethics of care, a relational ethics grounded in moral commitments between people in their particular contexts, which emerged from research on families, households, and healthcare. There are two case studies that illustrate that the ethics of care is not necessarily limited to micro practices shaped by women's traditional roles as caregivers. One case is on "caring finance" in Rabobank, and the other is on gender differences in financial behavior. They illustrate that the ethics of care deserves more attention from economists.

Keywords

Deontology, ethics of care, financial crisis, gender, Rabobank, utilitarianism

Introduction¹

Academic interpretations of the financial crisis often refer to “thick concepts,” as Amartya Sen calls them, which have both descriptive and normative value. As Ricardo Crespo and I argued in an ethical analysis of the financial crisis (Crespo and van Staveren, 2012), we see references in the literature to “hiding risky situations,” “excessive liberalization,” “extremely high bonuses,” “irresponsible loans,” “failing control,” “regulatory capture,” “perverse incentives,” “moral hazard,” “too rosy assessments,” and “excessive liquidity related to consumerism” (Blundell-Wignall, Atkinson, and Lee, 2008; Narayan, Ferri, and Brem, 2008; Acemoglu, 2009; Hart and Zingales, 2009; Nothwehr and Manning, 2009; Schneider and Kirchgässner, 2009).

Neoclassical theory, with its efficient market hypothesis, normal probability distributions of risk, and a self-interested logic of principal–agent interaction, reflects a particular underlying ethics. This is a specific form of the ethical framework of utilitarianism, which foregrounds a highly subjective, individualist interpretation of utility. This, I will argue in the next section, is part and parcel of the underlying causes of the crisis (see also Crespo and van Staveren, 2012). In the following section, I want to briefly discuss two other ethical frameworks, namely deontology and the ethics of care. The reason for doing so is that the ethics of the crisis and financial reform can also be understood by reference to alternative ethical frameworks. The recognition of such alternatives by professional economists will help to demonstrate what alternative behavioral paths are available for successful financial sector reform. The last part of the paper presents two case studies in alternative finance, which emerged in response to the crisis. These case studies show how an ethics of care may

translate into a meaningful and economically sound alternative in the financial sector, and induce more appropriate behavior by financial sector professionals. The paper concludes that regulation may be important to prevent crises and to guide financial reform after a crisis, but emphasizes that a caring ethical approach is just as important for economists, precisely because it generates less crisis-prone behavior in finance, and informs financial innovation toward more stable and sustainable finance, supporting the real economy instead of endangering it.

Utilitarian Economics Contributing to the Financial Crisis

Neoclassical economic rationality, embedded in utilitarianism, only considers the best way of satisfying preferences, regardless of the specific content of those preferences and whether this satisfaction causes harm to others. The moral characteristics of the behaviors just before the crisis mentioned in the introduction are preferences or individual maximizing strategies that have no place in utilitarianism. In utilitarianism, the highest moral good is utility or, in contemporary interpretations, preference satisfaction. As explained by the founder of utilitarianism, Jeremy Bentham (1789), an action is considered morally just if and only if no alternative action generates greater happiness for those involved. Utilitarianism is therefore a consequentialist ethics: the good is evaluated strictly in terms of consequences. In the aggregate, utilitarianism considers everyone's utility as equal; hence, it applies the impartiality criterion. The content of the good, however, remains hidden in the black box of preferences where individual agents are concerned: we neither know nor care what people prefer, or what will yield happiness. Utilitarianism is a subjective and individualist ethics, which allows for preferences that may do good or bad to others, to society or the environment, and even to the individual's long run objective wellbeing, as is for example the case with altruism or, alternatively, addictions (van Staveren, 2001).

At the level of the firm, maximizing utility requires the maximization of profits, and all (legally allowed) strategies that achieve that end are deemed to be legitimate (Graafland, 2009). In this domain utilitarianism is an ethics driven by markets: competition on unregulated markets dictates firms' strategies for profit maximization, through innovation, cost reduction, and economies of scale, which are selected through cost-benefit analyses. Moreover, the ethics of utilitarianism may involve the specification of rules, as in rule-utilitarianism (Broome, 1991), that when generally followed serve to maximize aggregate utility. Such rules allow agents to make decisions in environments when it is not practical for them to calculate the full set of consequences of their actions. Such rules may include behavioral rules in finance, for instance, which are individually rational. But as we've now learned, when the same rule is followed by many agents at the same time, the result may be collectively irrational because the behaviors may generate self-fulfilling prophecies that drive financial values quickly in the same direction without correction by the market.

The length of the time period over which utility is maximized depends on the individual's or society's time horizon and discount rates. Long-term consequences may or may not have an important weight owing to existing preference orderings, and the discount rates that are used to calculate costs and benefits when comparing alternative courses of actions.

It is important to note that utilitarianism is not necessarily self-centered: the interests of others can be taken into account, as enlightened self-interest, when this is necessary to maximize one's own utility. Or one can derive utility from increasing someone else's happiness when doing so yields a warm glow, so to speak. But in both cases, utility maximization remains selfish in the sense of its individual happiness-orientation: what matters in the end is one's own utility, for which someone else's utility may or may not be instrumental.

Under the system of a capitalist market driven by immediate shareholder value, and with volatile, unpredictable financial markets, utility maximization's time horizon is reduced to the short run. In such a market, professionals, firms, investors, and consumers can no longer patiently pursue the maximization of a lifetime utility function; instead they apply bounded-rationality to a long series of short-run utility maximization opportunities. This is because preference satisfaction is granted only in the short run—that is, a series of short runs such as quarters or at most a year, in which financial results are produced, announced, and transferred into rewards that satisfy shareholder value. The underlying utilitarian ethic of economic rationality, hence, is also limited to short term rewards: the contribution to the good by capitalist markets is expressed by the rewards accumulated over a series of short run maximization periods, while the bad are reflected by the losses incurred, including negative externalities when unregulated markets fail. This is an inconsistency in the utilitarian framework.

If we evaluate the financial crisis according to such bounded-rational, serial short-run decisions, combined with utilitarian ethics, we find that the individuals and firms that gained in various short run periods, either because they directly maximized their returns or followed rules that helped them to maximize returns, did “the right thing.” But the crisis generated only a few ultimate winners and many more losers. That may be as a consequence of irrational behavior: not maximizing one's preferences even though the constraints would have allowed for a higher level of preference satisfaction. Or it may be because preference satisfaction and rule-following did not result in utility maximization, owing to unforeseen events, even though the behavior was in line with cost–benefit analysis based on available information of credit rating agencies, interest rates, financial product diversification, and so forth. However, much of the behavior leading up to the crisis can be considered rational in

terms of utilitarianism, because agents did follow rational rules with the available information to maximize their returns, thereby satisfying their preferences.

The utilitarian ethics underlying the behavior of financial professionals, consumers, investors, and regulatory bodies appeared to have been unable to signal in a timely fashion that things were going wrong. I will argue in this paper that the utilitarian ethics underlying much of the behavior leading up to the crisis had marginalized other ethical approaches, such as an ethics based on principles and an ethics built on intrinsically valuable relationships. In the remainder of this paper, I will try to show what these alternative approaches are and how they can be expressed in finance.

Two Alternative Ethical Approaches for Financial Sector

Analysis and Behavior

Deontology, also referred to as duty-based ethics, is concerned with acting in accordance with appropriate, inviolable principles or rules. These principles or rules are taken to be intrinsically right, irrespective of their outcomes. Deontological ethics is therefore not concerned with bringing about preference satisfaction or happiness, but with ensuring “justice,” “rights,” or some other ultimate value. A dominant form of deontological ethics is expressed in the Kantian categorical imperative. It states that one should act according to that maxim by which you can at the same time will that it should become a universal law (White, 2009). A more individual-oriented interpretation of its universalist implication is that one should act toward others as you would like and expect others to behave toward you. Hence, deontology is not an individualist ethics, as is utilitarianism, but a social and universalist ethics: it is concerned with justice, with what is considered as right for a society as a whole (White, 2009).

In the financial sector, a deontological ethics is reflected in regulation that ensures the protection of rights, duties and justice by central banks, governments, and the sector itself. Regulation by definition works by rule-setting and rule enforcement. These may be rules operating within banks, such as credit limits for consumer loans; rules embedded in risk models, which come into action at a predefined threshold of certain market values of assets; or the values of certain variables of a bank's financial healthiness, such as its capital ratio. From a deontological perspective, such rules codify the duty of agents not to pursue courses of action (such as taking on excessive risk) that violate the rights of others (such as their creditors). Another important type of regulation is by the state and its related authorities. There are the regulations that are imposed by central banks, guided by internationally established rules for international financial markets set by the so-called Basel Committee, in which the central banks are represented. Other public regulatory bodies include the European Monetary Union and ministries of finance. Their actions are clearly visible—the former in its reactions to the euro crisis and the latter in their deciding on and managing the bail-outs of failing banks in the recent financial crisis. In addition, there are also private regulatory bodies that help the market to value assets such as credits, entire banks, and even a country's bonds. These bodies are rating agencies, which give ratings of the financial reliability of actors or products in the financial sector.

Clearly, deontology as institutionalized in financial regulation failed as a moral guide in the financial sector. Property rights were destroyed and other injustices induced by the behavior of financial actors who disregarded their moral duties not to violate the rights of others. Obviously, it is not merely the amount of regulation that matters, but the quality of regulation. From a deontological perspective, financial sector regulation should be regarded as just or fair and hence, universally supported throughout the sector. Otherwise, it fails to achieve its chief purpose. Regulation failed in particular in terms of two of the moral

connotations listed in the introduction: excessive liberalization of the financial market, which allowed some actors to take risks that undermined the rights of others; and failed control of banks, partly through regulatory capture. Rules that came into being after the 1929 crisis had been removed by a strong bank lobby in the United States (Igan, Mishra, and Tressel, 2009), and new rules to govern new financial strategies and products, such as short-selling, credit default swaps, and derivatives, were not yet introduced even though these assets were being traded increasingly. Without a stronger commitment to the sanctity of rules, both in terms of rule setting and rule enforcement, deontology has limited moral capacity to prevent the next financial crisis. Moreover, rules alone are too limited to address the day-to-day ethical dilemmas in financial decision making. Rules can conflict, they can come in effect too late, and they may not take important feedback effects in the long run into account.

Unlike deontology, which relies on external enforcement of moral behavior in the form of inviolable rules, the ethics of care helps us to understand agents' behavior and firms' strategies from a deeper ethical sense. It is concerned with ethical reflection and deliberation by agents whenever they have the space to make different choices. The ethics of care was first developed by Carol Gilligan (1982), who studied gender differences in moral reasoning. The ethics of care is attentive to the interpersonal level, where ethics is concerned with sustaining human relationships and preventing harm to others (Waerness, 2009). In the words of care ethicist Virginia Held: "Whereas justice protects equality and freedom, care fosters social bonds and cooperation" (Held, 2006: 15). And it is here where the other moral terms that we have seen in the introduction will come into the picture—terms concerning hiding risk, excessive bonuses and other perverse incentives, construction of securities that no one understands, too rosy credit ratings, and the consumerism encouraged by extremely low interest-rate policies. These moral dimensions of the crisis have much less to do with regulation than with the responsibility of the agents involved vis-à-vis other agents and

organizations. The ethics of care enables a fundamental shift in the parameters of the financial market. “With the ethics of care and an understanding of its intertwined values, such as those of sensitivity, empathy, responsiveness, and taking responsibility, we could perhaps more adequately judge where the boundaries of the market should be” (Held, 2006: 119). It is important that economists learn about the ethics of care in their education, both at university and later as professionals. This would allow them to see beyond utility maximization and its limitations and to seek more varied roles for the government in relation to the financial market beyond that of protector of rights or rule maker and keeper, as Held rightly argues.

In the ethics of care, preventing harm to others is contextualized. It is not abstract, as is the rule of non-intervention or a set of rules based on principles. Instead, it stems from and is inherent in the relatedness of actors. Preventing harm to others therefore requires taking responsibility for the consequences of one’s actions, not only as an individual but also through institutions, and responsibility for preventing the system in which one functions to turn into an uncontrollable chaos causing harm to all involved. Care also involves sympathy, in the sense of being able to place oneself in the shoes of others, as explained by Adam Smith. Sympathy is not limited to particular others known to oneself, nor an abstract, generalized other that is similar to oneself as in the categorical imperative—it also extends to concrete others whose circumstances are imaginable owing to the general information one has about their context (Benhabib, 1987). Preventing harm to others, then, requires contextualization to be able to know how others are in their concrete situation and what our responsibilities to them would be.

When applied to the economy, the ethics of care is expressed through efforts to minimize harm in day-to-day practices that have possible harmful effects on others, whether these would come from free markets, government regulation, intra-firm self-interested behavior, power-seeking strategies, or any other behavior in any economic sector. Possible

harmful effects of behavior abound because of imperfect markets, risk alongside uncertainty, and a wide variety of motives including harmful ones. Uncertainty is particularly important in this regard. Uncertainty, which goes beyond risk because the probabilities of possible future events are unknown, significantly influences financial markets. Keynes, of course, already knew this, as Skidelsky (2009: 75) notes: “Keynes believed that in many situations market participants face irreducible uncertainty. They have no basis on which to calculate the risks they face in making an investment. They are plunging into the unknown.” This condition implies that any economic sector is always in transition and may face discontinuities and disruptions, as Keynes noted, and does not jump from equilibrium to equilibrium, whether by free market forces or state interference. And in transition, rules are often not applicable or not yet established. This fragility of economic life and human fallibility in economic decision making under conditions of uncertainty results in harm calls forth government regulation that is, although necessary, utterly insufficient (see also Hellwig [2008] on systemic risk regulation). It is precisely such fragility and fallibility to which a caring attitude responds, by contextual reasoning. Such contextual reasoning is also what Keynes pictured as the most adequate response to financial crises. He stated, as recounted by Skidelsky (2009: 76) that the cures “are not meant to be definitive; they are subject to all sorts of special assumptions and are necessarily related to the particular conditions of the time.” Hence, with the current renewed attention to Keynesian policy responses to financial instability, I suggest that economists also begin to apprehend the underlying contextual ethics of such responses, as a sensible alternative to utilitarianism as well as deontology.

Case Study on “Caring Capital Financing”

This section presents a case study of a new capital funding product that a major Dutch bank has developed in response to the crisis and that has attracted much attention from investors

and regulators worldwideⁱⁱ. An example of a caring financial innovation, it was developed by two senior bankers in the context of regulatory pressure, limited liquidity in a hesitant capital market, in a cooperative bank structure with a client-value orientation. The case study points out that a caring attitude partly depends on an enabling institutional context.

Rabobank, a top-three Dutch bank and market leader in savings, mortgages, and agricultural lending in the Netherlands, has issued an innovative form of senior debt, called the Senior Contingent Note (SCN), as a response to the crisis.ⁱⁱⁱ In the first instance, the SCN is in a way to raise capital for the bank through bonds. The value of the bond does not appear on the balance sheet unless the bank's equity capital ratio were to fall below 7 percent. In that very unlikely case the bank's core capital will be strengthened as the bank will receive 75 percent of the value of the outstanding SCNs. Hence, those who bought the bond will lose 75 percent of their investment.^{iv} In exchange for that risk, the interest rate that bond holders receive includes a risk premium.

Rabobank is the only large Dutch bank that did not need state support, that kept a healthy equity capital ratio and its triple A rating throughout the crisis, merely dealing with collateral damage spilling over from other banks that were hit seriously by the crisis.^v Rabobank is a cooperative bank, so it cannot raise capital through issuing shares, and it is not listed on the stock market.^{vi} Although about 85 percent of Rabobank's activities are in the Netherlands, about half of its capital is raised abroad. The major way in which the bank raises its capital is simply through retained profits. Another recent innovation of the bank has been to raise capital and at the same time involve members more closely, as capital providers to the bank involves the issuance of certificates to its members (Rabobank clients can become members of the member council of their local branch). But this is a small scale initiative through the local, independent branches; the SCN targets large investors such as pension funds and globally operating investment funds.

The SCN was not developed at the international branch of the bank where the financial traders are based, in the fast world of short-term transactions and the balancing act between long term obligations and short-term liquidity. Instead, the new type of bond was developed at the treasury of the bank, as part of its long-term funding strategy. The challenge during the crisis was how to gain access to liquidity in a drying up market (which hit Europe especially hard due to defaulting governments, such as that of Greece) while staying true to the bank's conservative capital position (for which it had been criticized before the crisis as being not profitable enough, but later earned the bank its triple-A rating throughout the crisis). In a market, crisis risk and uncertainty are the major factors that investors are worried about. Moreover, during a crisis, risks turn into uncertainties, as rating agencies cannot assign reliable probabilities to the chances of default for institutions or even for individual products.^{vii} The strength of Rabobank is precisely its prudence—its higher than average equity capital ratio, as compared with most other banks, which gave it a boring image in the booming years before the crisis. This asset—prudence—was the basis for developing the SCN. The product was developed internally with consultation of a few large investors. Whereas Rabobank initially planned a 100 percent core capital strengthening with the new product, investors made clear that that would be deemed unacceptable by the market. A different case of Lloyd's in London half a year earlier,^{viii} but with similarities, has led to the current 75 percent ratio of the SCN to be added to the balance sheet in case the bank's equity capital ratio falls below 7 percent. The investors run a risk and, unlike typical shareholders, do not benefit from riskier projects undertaken by the bank that may bring in more short-term profits. Instead, they will demand that the bank either increase its buffers or raise the premium on newly issued contingent notes. The interest rate was not discussed at these sounding board meetings with investors, until the last week before the transaction on March 12 2010 in a meeting with four major investors. The interest among institutional investors as

well as private investment funds was overwhelming, both nationally and internationally (London, Paris, Frankfurt, New York), so much so that the transaction of the 10-year fixed rate Senior Contingent Note, priced at an annual coupon of 6.875 percent, was twice oversubscribed. Its issuance generated 1.25 billion euros.

Prudence—putting the responsibility for risk taking where it should be, namely the providers of capital—made it possible to find a market for this product. But it was also the pressure coming from regulators that led to the development of the SCN. Without the crisis and the subsequent call for (re-)regulation of banks and financial markets, it would not have been developed, at least, not now and not in this form. Regulators in the Netherlands and Europe are discussing implementing a bank tax, with equal rates across all banks, to form a fund that in case of need would become a lender of last resort. However, such a fund does not solve the problem of moral hazard, and does not reward conservative banks for their conservative positions and subsequent higher capital ratios. Therefore, a second reason for developing the SCN was to influence regulation, as both Basel III agreements and European Union law were being crafted and are still in the making. In other words, rather than focusing on lobbying against a bank tax (which they also did to some extent), the SCN represents a different type of incentive for banks and by banks, to increase their core capital in case of crisis, but with the great advantage that it reduces moral hazard by providing an incentive for the issuing bank to keep its equity capital ratio up by keeping risks manageable. In case of a bank having an inadequate capital ratio, the 75 percent shift of the loan to the balance sheet would imply that the equity capital ratio would be increased automatically, based on the rule imposed by the SCN, so that the bank does not (immediately) require financial support by the state, and hence is not a burden on taxpayers. This characteristic of contingent capital allows banks to increase their capital ratio in a more effective way than through issuing new shares because the prices of shares are currently very low and demand for them is inadequate.

Moreover, a contingent capital product like SCNs would help to reduce the likeliness of another crisis. In particular, SCNs reduce the chances of crisis caused by excessive risk-taking by banks (as is the case with the current crisis). It does this by forcing banks to keep risks relatively low to prevent the equity capital ratio from falling too much by leveraging too much. The SCN can also be seen as a strategic move to influence regulation, which indeed did raise attention from regulators all over the world. This feature of the development of SCN hence can be characterized as taking a long-run and systemic view: it involves the banking sector itself recognizing the dangers associated with financial market volatility and the need to undertake effective responses—all of which signal an attitude of responsibility. This is not the kind of self-sacrificing responsibility that entails risking one's survival, but the kind of responsibility that reflects a liberal attitude of accepting the consequences of one's individual actions on the whole, including financial sector participants (such as clients and investors) and also nonparticipants who bear negative externalities (such as taxpayers). This is the responsibility that Adam Smith wrote about, that does not constrain markets, but rather, supports the effective functioning of markets. The SCN, and hence, the economists in the bank who developed it, express this responsibility because it is a self-regulating instrument that prevents banks from taking excessive risks and diminishes the need for costly bail-outs and compensation of clients' deposits in times of crisis. It is, in the end, a mechanism that puts the risk where it should be, on the shoulders of the capital providers of banks, rather than on its clients or the taxpayer. It is therefore a good illustration of how an ethics of care can function in the financial sector.

Finally, why was it a cooperative bank that developed this innovation? Why did it not emerge within equally big banks listed on the stock exchange, such as ABN Amro or ING? This has only indirectly to do with the cooperative structure of the bank. The idea did not come from the member council, not the local ones, and not from the central membership

council. So, as much as the bank is driven by client value through close contact with its members and other clients, this did not play a role in the SCN. But it was the lack of access to capital through shares that drove the bank's treasury to be innovative and to develop a product that would on the one hand build on its conservative position and on the other hand even strengthen its image in the market as a prudent bank, by providing an extra buffer for its capital ratio. In other words, the other banks did not develop such a contingent note simply because their equity capital ratios were too low. In the words of one of the interviewees: "we do not have the shareholders pressure, which is an enormous benefit" and thereby it also "protects against moral hazard internally" and "pushes to be creative to raise capital if you can't do it through equity." This confirms Keynes' insight that it is the capitalist system based on equity capital that generates the uncertainty and subsequent systemic risk in financial markets. Skidelsky (2009: 84) reminds us: "Under capitalism, uncertainty is generated by the system itself, because it is an engine for accumulating capital goods whose rewards come not now but later. The engine of wealth creation is at the same time the source of economic and social instability."

In conclusion, the contingent capital product of Rabobank may be characterized as a caring form of capital financing because it is a form of self-regulation that lowers the risk of default, while reinforcing the bank's good rating. This, in turn, lowers the costs of capital funding, which makes it a solid product not only for the bank but also for the financial market, without the moral hazard of shifting risk to clients and tax payers. The SCN therefore carries a positive externality as compared to share-based capital funding which has a negative externality—it reduces systemic uncertainty in the financial sector. It therefore provides a good illustration to the economics profession on how to follow an alternative ethics, rather than utilitarianism, and still act economic rationally. Indeed, the use of an ethics of care may

be more rational in light of financial uncertainty and the ever-shorter time horizons of financial markets.

Case Study on Gender Differences in Financial Behavior

During the crisis, but also well before it broke out, women fund managers in the United States performed better than their male colleagues (Chang, 2010). Chang refers to an internal study done by AsiaHedge that concludes that female fund managers in the AsiaHedge Composite Index scored 73 percent better than their male colleagues between 2000 and 2007, and a report by Hedge Fund Research that shows that women performed 56 percent better than men in the period 2000 until May 2009. Moreover, during the height of the crisis in the second half of 2008, men lost twice as much money as did women. A recent study on mutual fund management in Egypt shows that women perform better than men in an emerging market (Ahmed Azmi, 2008). A study among 649 fund managers in four countries confirms that women are more risk averse than men (Beckmann and Menkhoff, 2008). A large study on gender differences in the mutual funds industry in the United States does not find statistically significant performance differences, but it does show that female fund managers follow more stable investment styles and show higher performance persistence (Niessen and Ruenzi, 2005). Linked to this, a recent survey by a major UK investment bank, among 2000 wealthy clients in 20 countries, showed not only that women are more risk averse in their investing, but also that they place more importance on financial discipline than do men (Barclays Wealth, 2011).

These gender differences in financial performance are supported by many studies on risk in experimental economics, showing that on average women take less risk than men (see Croson and Gneezy [2009] for an in-depth review of experimental research on gender and risk).^{ix} As a consequence, under conditions of high volatility women perform better than men

because they take lower risk or take more time to study risks or include a wider variety of risk factors than men do. This might imply that under conditions of relative stability of financial markets men perform better than women, although this is not necessarily the case (see, e.g., van den Bos, Harteveld, and Stoop, 2009). A famous study by Barber and Odean (2001) using survey data from 35,000 US households on their portfolio investment behavior has shown that women performed even better under normal conditions of financial markets, controlling for risk diversification in portfolio choice. Men traded 45 percent more often than women, who tried less to beat the market. Their patience prevented them from unnecessary and costly trading. Hence, women's transaction costs were lower, leading to higher net returns on investment. In couples, men's returns were 1.4 percent lower, whereas comparing the behavior of singles, men earned 2.3 percent less in returns. The finding of less trading by women was recently confirmed in a survey among 2000 wealthy individuals (Barclays Wealth, 2011). The report also indicated that women use somewhat different strategies of financial discipline than do men: they more often use cooling-off periods and they more often avoid information about markets that may lead them to deviate from their long-term strategies. Hence, women seem to be less overconfident than men in their investment behavior.

Moreover, women seem to behave more contextually, which is central tenet of the ethics of care. A survey among fund managers found that women change their strategy more often when they are ahead of or behind the market—"they try to perform closer to the market development than men" (Beckmann and Menkhoff, 2008: 377). A study on pension fund investment indicates that women tend to diversify their portfolio slightly more than men, and are less likely to sell when markets are down (Vanguard, 2011). However, in a study using a large database on chess playing, it was found that men adapt their strategy when playing against women, whereas women do not (Gerdes and Gränsmark, 2010). Apparently, men are

more sensitive to a gender difference between players than are women. Men appear to play a more aggressive strategy when playing against women, and this effect is even stronger when a male player is on objective grounds (measured with the Elo rating system) weaker than a female player. This reaction to women by male players reduces their winning probabilities, controlling for various other factors: a solid strategy has a 1.5 percentage point higher probability of winning as compared to an aggressive strategy, a difference that is statistically significant. Again, this points to overconfidence among males in risky, strategic settings.

The findings reviewed above are not necessarily driven by nature—these are precisely the key features of the investment strategy of Warren Buffet, portrayed recently in a book under the title *Warren Buffett Invests Like a Girl—and Why You Should, Too* (Lofton, 2011).^x Moreover, it is not only experimental economists and other academics who have found gender differences in financial behavior. The financial sector itself is increasingly aware of these differences, though only very slowly following up on these, with the top of the sector protecting its interests by keeping the circle of hiring and promotion largely within the old boys' network.^{xi} The nurture explanation suggests that women's socialization into societal norms about proper behavior for women as compared to men leads them to take lower risks, to have more self-restraint, and to react more contextually to changes in the market. This is supported by a recent study by Booth and Nolen (2012), who found that girls in single-sex schools exhibit the same levels of risk in games as boys, whereas girls in coed schools take lower risk levels.

Adolescent females, even those endowed with an intrinsic propensity to make riskier choices, may be discouraged from doing so because they are inhibited by culturally driven norms and beliefs about the appropriate mode of female behavior—avoiding risk. But once they are placed in an all-female environment, this inhibition is reduced. No longer reminded

of their own gender identity and society's norms, they find it easier to make riskier choices than women who are placed in a coed class (Booth and Nolen, , 2012:F74).

The nature dimension finds support in the empirical literature too. This has been analyzed in particular in neuroeconomics. A key study is among 17 male London City traders, testing for the relationship between two hormones, testosterone and cortisol, on the one hand and financial decision making and returns on the other hand (Coates and Herbert, 2008, and for a more general interpretation see Coates, Gurnell, and Sarnyai, 2010). Testosterone is known in the literature for the “winner effect” because it increases confidence and risk taking. Cortisol is sensitive to situations of uncontrollability and uncertainty, while it also affects the immune system. The traders traded in many assets but mostly in German interest rate futures, closing their trades at the end of the day, and were followed for eight consecutive business days. Saliva samples were taken twice a day (at 11 a.m. and 4 p.m.) and profits and losses were recorded at the same time. The study found that daily testosterone was significantly higher when they made above average profits. Also, on days of higher morning testosterone levels, traders made higher profits for the rest of the day than on lower testosterone days. The authors conclude that “because the days of high 11 am testosterone were different for each trader, thereby ruling out any general market effects on both testosterone and profits and losses, our results suggest that high morning testosterone predicts greater profitability for the rest of that day” (Coates and Herbert, 2008: 6168). On cortisol, the study found that the more volatile a trader's profits and losses, the higher were his average daily cortisol levels as well as the standard deviation in cortisol. This suggests, according to the authors, “that individual levels of cortisol relate not to the rate of economic return, as does testosterone, but to the variance of return” (Coates and Herbert, 2008: 6169). Cortisol rose in 38 percent of the subjects' days, sometimes up to 500 percent. Also, cortisol correlated strongly and positively with the volatility of the interest rate of the German Bund,

while testosterone did not. The authors signal potential negative effects for financial markets from their findings. First, when testosterone is chronically elevated, the literature indicates that it no longer has positive effects, but instead increases impulsivity and harmful risk taking, as well as euphoria and mania, and becomes addictive. This may exaggerate a market's upward movement. Second, chronically elevated levels of cortisol stimulate anxiety and a tendency to find threat and risk where none exist, which may exaggerate a market's downward movement. Together, the behavioral effects of these hormones may strengthen market volatility, and "help explain why people caught up in bubbles and crashes often find it difficult to make rational choices" (Coates and Herbert, 2008: 6171).

The mentioning of "people" in the last quote is interesting, given the fact that the sample only contains males. It may well be, of course, that women would express similar behavioral reactions to similar levels and changes in the two hormones. But the fact is that women's testosterone levels are much lower than men's, whereas, even though their cortisol levels are similar, women's bodies react much more than do men's bodies to higher cortisol levels with the secretion of the hormone oxytocin, which counters the production of cortisol and promotes nurturing and relaxing emotions (Nazario, n.d.). A study on oxytocin and altruism among a double-blind placebo-controlled sample of 96 male students in a public goods game has shown that receiving oxytocin (through a nose spray) positively correlates with the willingness to cooperate and the expectation that others will cooperate (Israel et al., 2012). This suggests that oxytocin indeed may have positive economic effects in a context of uncertainty, stress, and anxiety-based herd behavior. In line with these findings, a review article on the neurological foundations of economic choice concludes that the cognitive control processed by the dorsolateral prefrontal cortex of the brain is impaired during stress and depleted with repeated use (Fehr and Rangel, 2011). The authors conclude that "this predicts that subjects are more likely to make short-sighted decisions under stress" (Fehr and

Rangel, 2011: 24). So, in order to reduce increasing risk levels and market volatility in financial markets, a better gender balance on trading floors seems meaningful, both physically by replacing some male traders with female traders, and chemically, by administering oxytocin to male traders when market volatility increases.

Experimental game theory has also consistently shown that women are more cooperative than men (Croson and Gneezy, 2009). This has been shown with well-known games that test for attitudes that have moral as well as social dimensions, such as the dictator game, the ultimatum game, the prisoner's dilemma, and the public good game. Moreover, varying game conditions, such as a change in the members of the group or information about players, appear to have more effect on women's than on men's strategies. This suggests that women's reasoning in complex situations is more contextual than men's. Such contextual reasoning in complex social settings, involving ethical implications, is a major characteristic of the ethics of care. Indeed, Croson and Gneezy (2009: 464) conclude: "we believe, as suggested by Gilligan (1982), that men's decisions are less context-specific than women's."

The ethics of care is attentive to the interpersonal level, where ethics is concerned with sustaining human relationships and preventing harm to others (Waerness, 2009). In the financial sector, this can be done, for example, by recognizing the limited financial means of some people; recognizing risks that individuals, families or firms run; or recognizing how certain institutions that emerged, like systems of reward, may tempt people to behave irresponsibly in the knowledge that this will not be punished. Context, then, refers to livelihood, risk, and perverse incentives. In the ethics of care, preventing harm to others is contextualized and requires taking responsibility for the consequences of one's actions. Hence, put in this frame, the ethics of care can be used to analyze the financial system and banks operating in that system.

There is only very limited empirical literature testing for gender differences in moral behavior in firms (see, for a few studies, Robinson et al., 2000; Dreber and Johannesson, 2008). However, a recent experimental study with 96 MBA students (33 percent female) on buyer–seller information asymmetry has done a revealing test for understanding gender differences in ethical behavior before the outbreak of the financial crisis (Kray and Haselhuhn, 2011). The study finds that male participants more often identify with the interests of a buyer or a seller, changing their attitude toward sharing of asymmetric information, depending on whether they were assigned the seller’s role or the buyer’s role. Female participants more often identify with what they consider to be a fair relationship between buyer and seller, that is, revealing asymmetric information, irrespective whether they take the buyer’s role or the seller’s role. The differences were found to be statistically significant and indicate that women’s ethical attitude in a market relationship is more cooperative and oriented toward “fair play,” whereas men’s ethical attitude is more competitive and oriented toward protecting the interests of the market side that they represent. These results have led the authors to test gender differences in financial decisions.

Borrowing the metaphor from Kray and Haselhuhn (2011), would a hypothetical *Bernadette* Madoff have committed the same infamously unethical actions as the real *Bernie*? The current research suggests not, and importantly, offers an explanation as to why not. Though men and women may share common social and achievement motivations, they appear to differ in the extent to which their experiences and beliefs are called on to set ethical standards. By relying more heavily on their motivations, men derive considerable leeway in setting ethical standards, rendering them more vulnerable to ethical lapses (Kray and Haselhuhn, 2011: 12).

The literature indicates, then, that women are not only, on average, more cooperative than men, but that they also let their behavior be guided more by what they perceive as

morally good in relation to particular others in a particular context as compared to men. This suggests that women would be more inclined than men toward responsible behavior when relationships with others are involved.

This is not something that is acknowledged in firms, however. A recent paper by Lyda Bigelow et al. (2012) analyzed whether investors have equal confidence in female and male CEOs. The experimental set-up among 222 MBA students used hypothetical descriptions of CEOs that differed only in the sex of the CEO. The experiment has shown that “despite being identical in the experiment, the abilities and experience of female CEOs were evaluated more negatively than those of male CEOs” (Bigelow, 2012: 20). The authors suggest that the market does not see gender diversity in top management as a predictor of potentially better performance owing to gender-biased perceptions about female leadership.

The implication of this case study for the economics profession is that more women at the top—in universities and research institutions as well as in other institutions where economists hold institutional power such as the International Monetary Fund (IMF) and banks—will probably be a stabilizing factor for the economy in general and the financial sector in particular. Not because they would naturally be more caring—the SCN in the Rabobank case study was developed by two men—but because a combination of socialization and a bit of biology has made it more likely for women to be more risk averse, less overconfident in a competitive environment, and more flexible in their market strategies as well as their management styles. Hence, more women and more learning by males of women’s economic behavior would help to balance the economics profession far beyond the sex ratio in top positions.

Conclusion

This paper has reviewed two alternative ethical approaches to “doing finance”—both of them are yet poorly understood in the economic literature. Economists often mistake mainstream economics to be a morally neutral science. They are so convinced that they tend to see ethics in economics as comprising only deontology, because it entails acting in accordance with a rule or principle recognized to be right and just, even if it compromises the ultimate goal of utility maximization. In doing so, they fail to recognize that the “utility maximization” that neoclassical economics seeks is itself value laden and utilitarian in nature. Deontology has come out stronger after the crisis, often in the shape of a compliance attitude in the sector, both by regulators and in banks. The intention of this paper is to present an alternative to this dichotomous view of deontology constraining utility maximization. The alternative is the ethics of care. This is not an entirely new ethics in finance but resonates in the sector with its emphasis on integrity. The two case studies, one on careful financial asset development and one on gender differences in finance, illustrate the value of the ethics of care in finance. This ethics serves to introduce not only more stable and sustainable financial sector practices, “caring finance,” but also as an analytical framework for economists to understand behavior that does not fit a utilitarian set of assumptions or a deontological approach—“caring economics.”^{xii}

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Notes

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- ⁱ This paper is partly based on Crespo and van Staveren (2012) and van Staveren (2013). Some of the theoretical part is based on the first mentioned paper, while the case study on the contingency note by Rabobank is taken from the second mentioned paper.
- ⁱⁱ This case study is based on information released through the media, a presentation for investors, and an interview I held with the two key informants who developed the security at Rabobank’s capital funding department, Treasury Rabobank Group, Utrecht, May 18, 2010.
- ⁱⁱⁱ The transaction date was March 12, 2010, at the amount 1.25 billion euro for a 10-year fixed rate senior contingent note priced at an annual coupon of 6.875 percent. It was twice oversubscribed and sold to major investors across the world.
- ^{iv} In the past, convertible bonds were labeled as Tier 2 capital and institutional lenders were often supported in a bailout (Levinson, 2010). With new SCNs in the new situation after the crisis, it is less likely that regulators will protect these types of capital.
- ^v The cost of its bad loans in 2009 was nearly 2 billion euro, which was 0.33 percent of its balance total of 608 billion euro. On December 31, 2009 its equity capital ratio was 12.5 percent. Rabobank has always been profitable since its start more than a century ago, including in the crisis years 2008 and 2009.

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- ^{vi} The bank has 1.8 million members, which is a non-financial membership for any client but involves no claim on the equity of the 147 local banks. It is globally number one in several countries in the food and agri-business and has 623 foreign offices in 48 countries. The maximum bonus for senior management and executives is 30 percent of salary and half of the bonus is transferred only after three years.
- ^{vii} The top three international rating agencies, including Standard and Poor's, which together have more than 90 percent of the market, did not want to assign a rating to the SCN since they preferred to await new international regulation coming from Basel.
- ^{viii} Lloyd's is a listed bank, which failed to raise sufficient capital through issuing new shares. Hence, it issued contingent notes that would be turned into equity in case of predefined stress. It is different from the Rabobank case because Rabobank is not a listed bank and therefore has no shares.
- ^{ix} A recent report by the Deutsche Bundesbank on gender and age composition in boards of banks finds that banks increase their levels of risk when there are more women on the board (Berger, Kick, and Schaeck, 2012). This contradicts the findings of most empirical and experimental research on gender and risk attitudes. The report does not give an explanation for its findings but admits that there may be a relationship with age and experience for which it did not control. I suggest that the result may well be a consequence of men's reaction to the entry of women on boards. They may exhibit typical macho behavior, signaling to the women that they are "real men," increasing their levels of risk. This potential explanation is supported by a recent study with data from online chess playing (discussed later in the text) with 15,000 players (15 percent women) and 1.4 million games. It found that when men play against women, they choose more aggressive strategies, even though such strategies reduce their winning probability (Gerdes and Gränsmark, 2010). Further analysis into male reactions to women entering a male domain is necessary before any conclusions can be drawn on whether a change in risk profile of a bank is driven by an increase in women on the board or by an over-reaction of the males on those boards to the entry of women in a traditionally all-male domain.
- ^x Lofton gives the following three-point advice to investors based on Buffett's experience and attitude: (1) Value and cultivate your relationships with people; (2) Learn from the masters, but be willing to question them; and (3) Be fair and operate in an ethical manner.
- ^{xi} An interesting example of a sector response to the insight of higher female financial performance is a new private equity fund set up by three women in the Netherlands, Karmijn Kapitaal, investing only in medium scale firms that have women on the board. See: [*http://www.karmijnkapitaal.nl/en/](http://www.karmijnkapitaal.nl/en/)[<http://www.karmijnkapitaal.nl/en/>]*
- ^{xii} 'Caring for Economics' was the title of my PhD dissertation in 1999. It was published two years later as *The Values of Economics* (van Staveren, 2001).