

# How improper use of money can lead to economic and financial disaster.

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**Modérateur:**

**Luc VAN LIEDEKERKE**

President - EBEN (European Business Ethics Network) (Belgium)


**Speakers:**

**Alex MARKEVICH**

Consultant in business strategy and sustainable development - Sustainable Value Creation (USA)

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Professor of Business Ethics at Loyola University Chicago (USA)



system design implies that incorrect incentives were created and blindly followed by economic actors. An example of this is the process of securitization. This process implies converting a loan into a marketable security which allows the seller to shift the risk to the buyers.

According to Mr. Boatright this is a marvellous innovation with many benefits but which requires much more regulation. This is due to the fact that securitization changed incentives in banking. First, it disincentives the commercial banking sectors' traditional activity of taking deposits to make loans which are assessed thoroughly and are supported by a reserve cushion. Second, since it allows risk shifting, banks have no incentive to do due diligence. This also incentivises excessive lending practices which means they generated more loans than normal. Lastly, it deepened the conflicts of interest that the rating agencies have.

The workshop took place on Friday November the 20<sup>th</sup> in the afternoon. The moderator was Luc Van Liedekerke and the speakers were John Boatright, professor of business ethics and Alex Markevich, consultant in business strategy and sustainable development. The topics tackled were the causes of the financial crisis of 2008, the responsibilities of economic players and the means of control and regulation necessary to leave the crisis behind.

Mr. Boatright started by explaining that the crisis was caused by the failure of assumptions, market regulators and the whole system design. Failure of the

These changes in incentives will not cause problems if the assumptions on which the system is based hold, but unfortunately they do not. Therefore, bankers and investors who followed these incentives may not be blamed of unethical behaviour. The main assumption that does not hold is market efficiency which means that market prices are not correctly priced and that risk sharing is not efficiently born. This can be seen by the securitization of loans through CDOs which were incorrectly priced and bought by investors who could not handle the risk these instruments imply.



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Based on this facts professor Boatright concludes that unethical behaviour arises when market agents shift risk through securitization knowing that this risk will not be efficiently allocated. To prevent this behaviour he proposes an increase in regulation that supervises risk shifting.

Alex Markevich gave a more controversial view on the financial crisis and which measures should be taken to avoid a comparable collapse in the future. The crisis is, in his view, the result of a flawed system. The capitalism system is beautiful yet it is based on constraining assumptions that do not hold in reality and causes flaws: efficient markets, no externalities and no information asymmetry. However, what most analysts and economists forgot is that the theory is based on some unrealistic assumptions. It's important to focus on reality, not on what's beautiful.

The system is simplified (doesn't contain all variables) and dependant on historical data. However these data are not adjusted on the changes in economical context over time. This also means that models do not adapt or innovate based on the changing context.

Markevich also mentioned that risk management is incorrect because it is based on the assumption of normal distribution. Yet extreme events happen more often than the normal distribution implies.

The speaker proposes a redesign of the financial landscape based on the following four point system design:

1. Know what you want (main objective)
2. Get what you want efficiently
3. Keep priorities straight
4. Keep it simple

Applying this system, he concludes that the main objective of the financial system is to support the real economy. To get this efficiently it is necessary to prioritise the activities that relate financial activities with real economy activities.

Economical stability for example is prior to high growth and excess in profits. The sustainability of a company is prior to short term profits. Applying this theory in practice means that banks should have a supportive role towards the 'real' economy. This implies that risk management, liquidity and redistribution are secondary to real economical stability.

In conclusion the solution to actual economic problems is changing the incentives of the system so that they are linked to the real economy. In this context Markevich discusses the use of the gold standard. This system should link the emission of money to a real asset, in this case gold, to avoid huge trade deficits and inflation.