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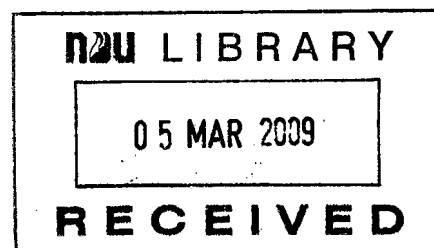
**Bordeaux Business School
Institute of International Business**

The Ethics of Financial Institutions:
Portfolio Management Perspective

**A Memoir Submitted in Partial Fulfillment of the
Requirements for the Joint Degree of the Master of Business
Administration (M.B.A.) and the Master of Science in
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Approval Certificate

THE ETHICS OF FINANCIAL INSTITUTIONS PORTFOLIO MANAGEMENT PERSPECTIVE

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DECLARATION

I hereby declare that this Memoir is entirely my own work and that it has not been submitted as an exercise for a degree at any other University.

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FULL NAME

ABSTRACT

When investors access to financial institutions' services, they usually look for a financial partner who will ensure their belongings' safety, respect their privacy and deserve their trust. Unfortunately, in light of the recent financial market collapse, proofs have been found that many of these institutions were not worthy of their clients' trust. The blunt reason behind that fact has been their lack of ethics.

Due to the absence of financial advisors' honesty, integrity and transparency, many investors, at the international scale, saw their properties being wiped out, without understanding the grounds of their misfortune. They were just unaware of their risk exposure.

When it comes to managing portfolios, and by the mere fact of being a financial advisor, it is of utmost importance to ensure the advisee is conscious of his risk exposure when investing. Assessment of investor's profiles should precede asset allocation. As this has not been the common practice in many banks, room for unfair and deceptive trade practices has been made.

Indeed, a review of advisees' risk appetite and financial know how showed great discrepancies between their investors profiles and their portfolio holdings. Subsequent questionnaires and interviews revealed a lot of misunderstandings about portfolio management techniques.

As ethics include due care, honesty, integrity and transparency, and since clients' interests should be one of the banks' main objectives, a system controlling financial advisors' practices is to be put in place.

Keywords: Financial advisory ethics, investor profile, asset allocation, budget making practices, consumer protection.

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Chapter 1 Ethics of Financial Institutions

Introduction

Nowadays, as the global financial market expands and develops, profit and budget targets are more than ever banks' ultimate goals. Competitiveness, reputation, and market share are sole key targets to most international financial institutions. As a result, and in general, ethics are being left a small part in the investment practices. But if it is actually the case, does it mean that it is correct, just and fair?

As a result of the subprime mortgage crisis, international banks and financial institutions are facing liquidity issues. The crisis began in late 2006 in the United States banking system and triggered a global financial crisis during 2007 and 2008. Its core reason was that loan incentives and a long-term trend of rising housing prices encouraged borrowers to assume mortgages, believing they would be able to refinance their debts at more favorable terms later. However, once housing prices started to drop moderately in 2006-2007, refinancing became more difficult, and US housing bubble burst. Afterwards, the main problem the global economy faced was the start of consecutive write downs made by major international banks. Those were mainly due to hopeless refunding of the majority of mortgages made to high-risk borrowers with relatively low income and/or bad credit history. The consequence was the tightening of liquidity available to financials.

Of the above stated problem, two ethical questions arose: First, were institutional clients – who happened to incur losses- aware of the risk scope when investing in Asset Backed Securities and Mortgage Backed Securities? Second, have retail clients been misled by international banks credit rating? In both cases, three issues are highlighted: the transparency of financial institutions (securitization vehicles mainly), the competency of credit rating agencies and the ethics of financial advisors. Although finger pointing and blame can be put on a wider pool of involved parties, this document will rather focus on the ethics of financial advisory units.

1.1 Overview of markets' trend

Before proceeding, a global outlook should be drawn. As US dollar has been weakening, and as the European Central Bank has been maintaining its interest more or less fixed, the probability of seeing the dollar gaining back momentum is day after day becoming minimal. Consequences are as follow:

At the international scale, investors lost confidence in the US economy, for one, and for another, most of them are becoming relatively conservative and risk averters. As for the Levant investors, already having a conservative investment profile, they are looking more than ever for alternative investments. The problem resides in the facts that most financial products marketed to them are dollar denominated, and that their lack of knowledge in the investment arena (relatively to international investors) cannot but increase their exposure to risk.

Looking at the other party of the investment relationship, banks are introduced. The latter trading books are at stake. They badly need to cover losses and to access rapidly liquidity, and it is exactly that speed rush that raises additional ethical issues. Levant banks find themselves limited by Basel II and Central bank procedures and cannot take long positions but in very specific assets and cannot take short positions. The left alternative is to increase profitability by rising clients' transactions frequency. Considering the highly volatile and predominantly bearish market, such a solution would be by far judged unethical, unfair and inadequate in the long term.

We therefore find ourselves in a conflict of interest situation whereby one end needs additional care and extra-precautious advices, and the other needs more risk taking clients to be able to maintain profit level.

1.2 Ethics vs. Banks' liquidity needs

In the short term, a prosperous bank can brag about its profits, but in the long term, clients run away if these profits have been made at their (clients') expenses. Although this statement speaks for itself, we can unfortunately encounter banks that still prefer to increase their profitability on their clients' accounts. Indeed, there are some banks that still favor high and arbitrary commission charges, and that implicitly encourage its financial advisors to conduct random sales

of financial products to boost their respective budgets instead of advising correctly on investment. Sadly enough, profits are shared between the bank and the client, whereas losses are solely bear by the client portfolio. It is this kind of practices that justify mainly the choice of our topic: “The Ethics of Financial Institutions- Portfolio Management Perspective”.

It is also important to highlight how often clients rights are breached, and how recurrent are the cases where clients are uninformed of what they are entitled to know and receive. Among those, there are some rights- as questionnaire revealed- that the clients ignored totally:

When they entrust their money to a financial professional, the latter has a duty to perform to a certain standard. In other words, as investors, they have a number of rights, and if any of these rights have been declined by the broker or advisor, they are entitled to sue to the latter.

Among the rights that are worth mentioning, a client has the right:

- To ask for and receive information from a firm about the work history and background of the person handling his account, as well as information about the firm itself
- To receive complete information about the risks, obligations and costs of any investment before investing
- To receive recommendations consistent with his financial needs and investment objectives
- To receive a copy of all completed account forms and agreements
- To receive account statements that are accurate and understandable
- To understand the terms and conditions of transactions he undertakes
- To access his funds in a timely manner and receive information about restrictions or limitations on access
- To discuss account problems with the branch manager or compliance department of the firm and to receive prompt attention and fair consideration of his concerns

- To receive complete information about commissions, sales charges, maintenance, custody or service charges, transaction or redemption fees, and penalties
- To find out if an investment is permitted to be sold and to file complaints

Source: Financial Industry Regulatory Authority

Before continuing our presentation on the need of this topic, I would like to remind the reader of the following legal classification of clients: If we refer to the United Kingdom Financial Services Authority, we would end up with 3 clients' categories:

The first, being "retail clients": a retail client is any client who is not a "professional client".

The second category involves "professional clients". Those are entities with the experience, knowledge and expertise to make their own investment decisions and properly assess the risks that they incur. For the sake of comparison, requirements to fulfill the status of professional clients are listed below. Two out of the three following requirements should be met:

- Balance sheet total of 20 million Euros
- Net turnover of 40 million Euros
- Own funds of 2 million Euros

The third category includes "eligible counterparties": those are considered the most sophisticated investors or market participants, although they are limited to certain types of business: Execution of orders, dealing on own account basis, receiving and transmitting orders and/or servicing directly the above types of business. The point behind displaying these categories is that in any listing authorities, there should be such classifications if clients are to be treated fairly. For instance, in Europe, the MiFID (Markets in Financial Instruments Directive, which is part of the European Union's Financial Services Action Plan) determines the levels of regulatory protections that each client is granted depending on the category it falls under. There should be a trade-off between knowledge and protection levels if corruption and misuse of control are to be avoided.

Now although the less savvy is the client, the more should he be protected, it is important to note that losing money on an investment does not mean clients can sue their advisor for bad advice.

When they invest, they must be aware that they are taking on some risk against which no law or regulation can provide protection. However, they could complain in case of misrepresentation and unsuitability: Misrepresentation being the falsehood or omission of facts in related to an investment, and Unsuitability occurring when a financial advisor or broker invests a client's money in a security that is not suitable for the customer's investment objectives, by, for example investing large sums of money in high-risk securities for a person who has a low risk tolerance.

Consequently, among the concepts that advisors should clarify to their clients is the risk/return tradeoff. At all time, advisors should be able to identify what amount of risk the client can take while remaining comfortable with his investments. Furthermore, they should make sure that the client understood that higher risk gives him the possibility of higher returns, that there are no guarantees and that just as risk means higher potential returns, it could also mean higher potential losses.

Another aspect of providing ethical advices is to make sure the client knows to whom to refer should there be a legitimate dispute. The client should be aware of the legal bodies in charge of settling such conflicts (in the US, for e.g. it is the SEC Securities and Exchange Commission that is in charge of such disagreements). Also, it is worth noting that if the organization is a member of a charter organization, complaints could be filed with the charter organization board, as these tend to always have standards and codes of ethics.

Finally, perhaps the most important aspect of private bankers' characteristics is honesty. An honest and credible advisor is one who will spend time to ensure that the client fully understands an investment beforehand. Pros and cons of each investment product should be clearly enunciated. After identifying the client/investor profile, the advisor could involve the advisee in the asset allocation phase, whereby he would explain to him the relative importance of diversification techniques, and at a later stage, investment strategies reviews, like Dollar cost averaging, etc.

1.3 Purpose of the study

Planning bank profitability while favoring ethical and professional advisory, via the highlight of correlation between bonuses and portfolio performances

Private bankers or relationship managers are very often at the core of the bank budget making. Since higher charges are imposed on advisees (clients in our case) in exchange for their high worth services, they are most of the time pressured to increase the revenue coming out from clients' portfolio transactions when the bank overall profit is lagging behind target. And as they act as ultimate- even though legally "indirect"- decision makers, their power to harm clients' profitability is often greater than it should be.

We consequently end up with portfolio managers targeting higher sales figures in order to boost their end-of-year bonuses instead of managing objectively their clientele pool's effective gains. Although results, in the short term, look as achievements, in the long term, in the clients' mind, consecutive disappointments make the financial advisor status leave its place to the image of an expensive broker. To avoid such dissatisfaction, and in order to retain the valuable clientele the bank has gathered over the years, a bonus linked to clients portfolio performance instead of commissions charged to clients should be implemented, and that is exactly what is going to be introduced along this presentation.

To make sure a financial advisor is acting in his clients' best interest, some measures should be taken along with the correlation of bonuses with portfolio performances. Of primary importance is that he/she maintains regular contact with their clients. He should call them in both the good times and the bad and inform them if he/she thinks that any change in portfolio strategy makes sense, or if a new research report that the client might be interested in has been issued by the firm (for instance a firm of which the client holds stock). In case of inquiry from the client part, response should be given within a day, or at least a week, depending on the urgency of the matter. Most importantly, a good relationship manager should talk with his clients at least twice a year about their overall finances. Specifically, he should discuss the client's income and ability to save, as well as any longer term goals. He should then review any plans that have already been initiated, such as retirement plans.

Finally, an essential aspect of financial advisory is courtesy. After all, the client entrusted the relationship manager with his money, and since that is often clients' most valuable asset, the financial advisor should always feel responsible and privileged to have earned his advisee trust.

Before we continue the outline of how a financial advisor should act, I suggest we remind the reader about the aim of this study. This document's purpose is to set boundaries within which financial advisors should behave. Whereas management tends to focus on the revenue side of portfolio transactions, we aim to present the ethical side of the above stated advisory.

It all starts with underlying the importance of the account type. Indeed the account should reflect the client's investment style, or at least should be coherent with his ability to cope with risk. For instance, if the client's goal is capital appreciation, it should mainly be invested in stocks or mutual funds. If his goal is income, the majority of his funds should be invested in income-generating assets such as bonds. Consequently, investments that do not fit in with clients' goals should be considered suspect. Now how to track these discrepancies is the project we proposed to the management. As displayed later, each client will be asked periodically to share his investment views by filling a questionnaire. Once he does, a prototype asset allocation will be generated, where investment categories will be weighted relatively to his risk tolerance. The financial advisor will then ensure that adequate investments proportions are to be presented to the client. Of course, once this step is accomplished, the financial advisor will be required to get the clients' approval on targeted investments.

1.4 Budget making practices

Although client classification reduces generally the discrepancies between the clients' investment needs and wants and those of the latter' financial advisors, there are still some budget making practices that tend to escape the ethical filtering net.

1.4.1 Churning

A big concern clients regularly face is churning. This happens when clients sign the discretionary portfolio management form. Now it is true that a good broker actively manages his client's account, however, he should not be trading in and out of securities too frequently, or

overtrading, since this, most of the time, generates large commissions, and result in clients' reduction of principal. The worry is that advisors, once dealing on discretionary mode, could earn much more thanks to those commissions. Therefore, any trading that reduces considerably the clients' portfolio principal and adversely affects its returns, or which deviates from his investment objectives, should be questioned.

1.4.2 Shareholder and Stock Frauds; Investment and Stockbroker Frauds

It also happens that some traders/financial advisors have recourse to another source of commissions; a commission generated by the sale of an X company's stocks, where the dealer would have agreed with the company itself to market itself erroneously. The case would be include a company's accountants or executives intentionally masking profits, losses, debts, acquisitions, mergers, or other financial transactions. Because they know that shareholders rarely buy stock in companies rocked by excessive debt or suspicious activity, those executives may try to conceal that debt, inflate company profits, and cover up scandals in order to lure investors. Conspiring dealers might offer too-good-to-be-true stock deals so that shareholders think they are getting a superb deal when in actuality, they are just being used to prolong the company's inevitable crash. One of the best examples of shareholder fraud is the recent collapse of the financial giant Enron, which defrauded investors by concealing billions of dollars in debts before the company finally went bankrupt. Such misrepresentation of a company's true financial status has cost consumers millions of dollars collectively-and many have lost everything, including their life savings or retirements. Legally, in such cases, the company is accused of "Shareholder Fraud" and/or "Stock Fraud", whereas the broker is blamed to have engaged in "Investment Fraud" and/or "Stockbroker Fraud". An Investment fraud refers to when a company or stockbroker intentionally misleads shareholders in order to generate business and clients. For example, a stockbroker may lure a shareholder with padded stock reports that make a company look much more sound and lucrative than it truly is. Sometimes, a stockbroker will give a company whose stock he's trying to sell a higher rating so that investment banking firms will be enticed. By intentionally manipulating investors, the stockbroker could cause them to lose some or all of their money on stock they thought was foolproof. Merrill Lynch, Morgan Stanley, Deutsche Bank, Bear Stearns, and JP Morgan are among a dozen firms that were suspected or convicted of investment fraud.

1.4.3 Trading without Permission

Some brokers tend to both buy and sell stock on behalf of a client against his or her will believing they will help the client in doing so. In here, intentions cannot be used as excuses. Unauthorized trades on a client's account are illegal. Brokers do not have the freedom or luxury of making clients' activities in secret or against their wishes unless they have the authority to do so (cf. discretionary management case).

1.4.4 Conflict of Interest and Unethical Stock Reshuffling

When a firm provides stock analysis for its own investment banking clients or for companies whose business it hopes to secure, the potential for bias is great. Analysts may feel pressure to rate such stocks highly, even if they are not expected to perform well. Competitors of investment banking clients may be rated lower than they deserve to be if the securities firm is out to appease its own clients. Misleading stock reports created because of conflicts of interest can hurt investors. Investors may lose large sums of money because of the deceptive information they receive. Consequently, due to the mere fact that they housed both investment banking and stock analysis businesses, securities firms have been engaging in many conflicts of interest and found themselves dragged into numerous fines and lawsuits,.

Another example worth noting is that of the Broker Fund Advisors- those being the brokers responsible for funds activities. Those often recommend overvalued stocks to their private clients, the stocks being held by the fund managers they work for. Through this technique, the latter is able to reshuffle its stocks, while the other party ends up owning a stock that will most probably decrease in value, due to consequent block trades.

1.4.5 Insider Information

Insider trading refers to a situation in which a person with special information about a company's plans and dealings uses his knowledge to make trades. Although lucrative for the offender, insider trading can unnaturally alter stock prices and hurt outside investors. It is therefore unfair and illegal. Insider trading can be a temptation for directors, CEOs, brokers, stock analysts, investment bankers, and company employees. Family members or friends "tipped off" by such people may also be guilty.

1.4.6 Risky Investments

Although risk is inherent in all investments, some stocks have greater potential for losses than others. In general, the term "risky investments" refers to stocks that may yield high returns, but that also have a higher possibility of dramatic or total losses. Those could be buying on margin and investing in start-ups. Because of the possibility for significant losses, stockbrokers have the responsibility to explain the dangers involved in risky investments, only allowing investors to proceed if they are able to cope with the worst-case scenario.

1.4.7 Inaptitude, malpractice and misrepresentation

Professionals in many fields are expected to provide their services according to certain standards. Malpractice occurs when they do not perform according to those, and that resulting harm affects the person the professional was supposed to be helping. Brokerage malpractice happens when a stockbroker or stock analyst provides investors with grossly inaccurate, deceptive, unfounded, or misleading information. Usually, the brokerage firm employing the guilty party bears the legal liability. Another case is Misrepresentation. The latter is an illegal practice in which a securities firm or stock broker intentionally provides clients with incorrect or unfounded information for its own benefit. Misrepresentation can also occur if true information is withheld. For example, if a firm knows that a company's stock is likely to fall but continues to rate it highly (e.g. Enron), the firm may be guilty of misrepresentation. Misrepresentation hurts investors by allowing or encouraging them to buy stocks that are going to drop in value. Whether from ineptitude, self-interest, or malice, such mistakes can cause investors to lose money.

1.5 International perspective/application

Where theory meets practice and ethics gain meaning.

Ethics in the finance world, especially in capital markets, is needed more than ever as harm can be greater than expected in its absence. Regardless of cultures and differences in business procedures, great care should be exercised, especially toward less favored (less savvy investors) parties.

During the last decades, international financial markets increased their links and standardized their procedures to form a network of interlinked market exchanges. Geographical proximity is

no longer a must for those to interact in permanence. As they all started to form a global market exchange, efforts have been put to homogenize dealing systems, and in turn, to regulate financial advisory norms. The MiFID stands among the directives, laws, agreements that have been signed on by different countries.

MiFID is a European Union law which provides a harmonized regulatory regime for investment services across the 30 member states of the European Economic Area (the 27 Member States of the European Union plus Iceland, Norway and Liechtenstein). The main objectives of the Directive are to increase competition and consumer protection in investment services. As of the effective date, 1 November 2007, it replaced the Investment Services Directive. MiFID is the cornerstone of the European Commission's Financial Services Action Plan whose 42 measures will significantly change how EU financial service markets operate.

Of interest to us, it is well-known for its client categorisation. MiFID requires firms to categorize clients as "eligible counterparties", professional clients or retail clients (these have increasing levels of protection). Clear procedures must be in place to categorize clients and assess their suitability for each type of investment product. That said, the appropriateness of any investment advice or suggested financial transaction must still be verified before being given. We learn that under the aforementioned directive, there is a contractual duty of best execution that is owed to both retail and professional clients. For instance, best execution should take into account the characteristics of the following:

- Client
- Client order
- Financial instrument
- Execution venues

It is a contractual duty that requires the firm to provide the client with the best possible result. For a retail client, a consistent best possible result will entail getting the best price (inclusive of all additional costs such as the firms' fees). For a professional client, other than the price in itself, speed, likelihood of execution and settlement, and market impact may also be significant determinants.

As for the transactional level, it specifies how clients' orders should be handled. MiFID has requirements relating to the information that needs to be captured when accepting client orders, ensuring that a firm is acting in a client's best interests and as to how orders from different clients may be aggregated.

Another international effort is the pool of certificates that are very tight on ethics. As referred to, above, we will briefly introduce the CFA, as this kind of charter is narrowing margins of ethical dilemmas, mainly thanks to the increasing recognition it is gaining.

For unfamiliar readers, CFA stands for Chartered Financial Analyst. As declared by the CFA Institute, the aim of the CFA society is to set a higher standard within the global investment community and a set of values around which all of its programs, services, and initiatives revolve.

Its mission is to lead the investment profession globally by setting the highest standards of ethics, education, and professional excellence. Its vision is to have all serious investment professionals aspiring to be a part of it, to be where investment professionals go to first when seeking credentials and continuing education, and to lead the industry's thinking in the area of ethics, integrity, and excellence of practice.

Its beliefs are mainly that Financial markets should be equitable, free, and efficient so that every investor has a chance to earn a fair return ; that The interests of the ultimate investor must take precedence over the interests of all other market participants and finally that High ethical principles and self-regulatory standards are as important to market efficiency and fairness as rules and regulations.

The aim is to state that banks should encourage such initiatives, even when they do not have to respect literally the international directives and laws, otherwise ethical problems in the investment profession will tend to remain constant, if not increase.

Conclusion

Among the suggestions given to management, a point was made clear: a bank that really cares for its prestigious image, should know who to hire and how to retain talents. However, no matter

how performing a bank can be at the recruiting stage, it should always strive to keep its personnel up-to-date. In reality, it is constantly banks that encouraged their human resources to continue their education that have reached outstanding results. Concerning financial advisors, they are among the most needy to further their qualifications, especially nowadays, in such evolving conditions. Furthermore, it has been proven that the more they acquire knowledge (via acquiring certificates, licenses, etc.), the more professional they become. Later we will be discussing for example the Chartered Financial Analysts certificates, and as will be shown, this kind of degree does help in the shaping of the international finance community.

Other than the technical skills an advisor should have a highly ethical behavior. These could also be taught. In several cases, some advisors had arguments with their clients, even when they were outperforming the market. This happened most of the time when they tended to make promises that were not kept. Another reason of conflict was the biased sale of financial products, where the trader sold to his client some of his positions, knowing he could not get rid of them on the open market, or when the financial product turned out to be highly illiquid.

Lastly, an advisor should always inform the client of the reasons behind his portfolio performance, even when those are obvious. All clients should be enabled to benchmark his portfolio's performance against the performance of fund managers or indexes in order to compare their investment performance to the broader market. This does not mean that underperformance enables the client to blame financial advisors, but it would rather give an incentive for the latter to give his clients added value.

Study Outline

Now that broad guidelines to Financial Advisors/Relationship Managers have been depicted, it is only normal that implementation varies from a client/investor to another. Whereas some will need permanent and close follow-up, others may ask for and be granted more investment freedom and "laissez faire". To be able to classify them, a questionnaire aiming at assessing their know how has been conducted throughout this study writing period. As results will show, lots of discrepancies between investor risk profile will be introduced and. Its structure and objectives will be specified, and then an interpretation of results will follow.

Before going through the micro economic factor, the clientele pool, in Chapter 3. Ethical dilemma of Financial Institutions, the main actors involved in the subprime mortgage crisis will be presented as the latter repercussions on the portfolio management industry have been heavy. Consequently, and as mentioned earlier, financial advisory stricter regulations will have to apply. Therefore, suggested techniques to regulate Financial Advisory activities will follow.

Before portraying Levant investors' know how, and reasoning on today's financial markets crisis, the subsequent chapter will aim at describing general investors' rights by referring to principal ethics theories.

Chapter 2 Investors' Rights

2.1 Review of literature

Theories related to advisory have quite common points with those related to consultancy and counseling. They all state the importance of due care, tailor made advices and consideration of situational factors. The points on which they differ are at the level at which they accept or reject ethics theories. Among the latter, the most known are stated below. Before outlining those, let us remember few major definitions:

- **Morality:** The standards that an individual or a group has about what is right and wrong or good and evil
- **Moral standards:** The norms about what kinds of actions believed to be morally right and wrong as well as the values placed on the kinds of objects believed to be morally good and morally bad.
- **Ethics:** The discipline that examines one's moral standards or the moral standards of a society. They are of three kinds: Systemic, ethics of social systems or institutions within which businesses operate; Corporate, ethics of an individual company as a whole; Individual, ethics of a particular individual or individuals within a company and their behaviors and decisions.
- **Business ethics:** A specialized study of moral right and wrong that concentrates on moral standards that apply to business institutions, organizations, and behavior.
- **Normative study:** An investigation that attempts to reach conclusions about what things are good or bad or about what actions are right or wrong.
- **Descriptive study:** An investigation that attempts to describe or explain the world without reaching any conclusions about whether the world is as it should be.

Traditional view of moral corporate responsibility involves those who knowingly and freely order, advise, or encourage (or others who act or omit on these orders, advices or encouragements) what was necessary to produce the corporate act. The conflict comes about at the subordinates' responsibility level. Relatively to our case, when a financial advisor is urged by

the manager to increase transactions numbers, although he knows that the market bearish phase does not signal any recovery sign, and that any investment made during this period cannot but lose value- after sale occurs-, is a situation where we need to identify who will be morally liable vis-a-vis the unfortunate investor, and whether it is justifiable.

2.2 Ethical dilemmas of major Investment banks

When big banks are caught “la main dans le sac”

As mentioned earlier, the private banking sector is one where investors along with their designated market representatives (banks, brokerage firms, financial institution, consultancy firm, etc.) meet to maximize the value of their assets. Although one party serves the other by providing financial advices and services, and consequently the possibility to make profits, in return for charges and fees, it often forgets the presence of a third variable in the equation: ethics! By a matter of fact, some justify that there is no necessity to have ethics in business, and that after all, charges and fees cover the offered financial services, and that value is included in the latter.

If the above statement convinces you, you should then be able -probably- to explain how comes very well reputed financial institutions faced ethical problems that had cost them amounts equivalent to entire years' accumulated profits.

Morgan Stanley

Morgan Stanley is a lead global financial services firm that, through its subsidiaries and affiliates, provides its products and services to customers, including corporations, governments, financial institutions and individuals. The company operates in three business segments: Institutional Securities, Global Wealth Management Group, and Asset Management. It has been accused of giving preferential treatment to Gucci, because Gucci is one of its investment banking clients. In an unrelated but comparable case that involved 12 well-known brokerage firms, Morgan Stanley agreed to pay \$125 million in fines to the SEC but did not admit guilt. The allegations again related to allowing investment banking interests to bias its stock reports.

Charles Schwab

One of the United States' top discount brokerage firms, Charles Schwab, first emerged as an affordable alternative to larger, better-known securities firms. Despite its efforts to avoid conflicts of interests and other types of securities fraud, the firm has nonetheless been accused of other crimes, including charging higher-than-market prices for services and delaying billing for more than six months after investors' transactions were completed. Inevitably though, they had to cut back and downsize and subsequently the revenue fell 25%. Later on, it paid a \$350,000 fine to the SEC.

Merrill Lynch

Merrill Lynch & Co., Inc. provides capital markets services, investment banking and advisory services, wealth management, asset management, insurance, banking and related products and services worldwide, through its subsidiaries and affiliates. It is very well-known in the international market place, and benefits from a very good reputation. Still, in 2001, it allegedly gave good ratings to companies it knew were in decline, such as Enron. Although Merrill Lynch did not admit guilt, it was ordered to pay \$100 million in fines (what it reportedly earns in one day) and directed to make drastic changes in the company's organization.

Smith Barney Citigroup

Salomon Smith Barney, the investment banking division of Citigroup, allegedly gave false stock ratings to corporations during the telecom meltdown in hopes of attracting new clients and keeping current ones. The firm was charged with securities fraud, but it settled for \$400 million.

JP Morgan

JPMorgan Chase is one of the oldest financial services firms in the world. The company is one of the leaders in investment banking, financial services, asset and wealth management and private equity. In 2007, the hedge fund unit of JPMorgan Chase was the largest of its kind in the United States with \$34 billion in assets. Formed in 2000 when Chase Manhattan Corporation acquired J.P. Morgan & Co., the firm serves millions of consumers in the United States and many of the world's most prominent corporate, institutional and governmental clients.

Despite its top ranking, JP Morgan Chase & Co. had weathered a storm of securities fraud allegations. The firm allegedly facilitated Enron's fraud (and eventual bust) by providing funds to LJM2, one of the partnerships Enron's former CFO created as an attempt to conceal Enron's debt. JP Morgan also handled another company, Mahonia, Ltd., which prepaid Enron for services, making it appear that Enron was generating more money-and more business-than it really was. It consequently was included in the conflict of interest lawsuit brought forth by the SEC against multiple securities firms-for which the firm agreed to pay \$80 million in fines to the SEC. Both Enron's shareholders and JP Morgan's shareholders have filed suit against JP Morgan.

Goldman Sachs

Goldman Sachs has been the world's largest investment bank. Goldman Sachs was founded in 1869, and is headquartered in the Lower Manhattan area of New York City. It has offices in leading financial centers such as New York City, London, Boston, Chicago, Miami, Dallas, Los Angeles, San Francisco, Frankfurt, Zürich, Paris, São Paulo, Bangalore, Mumbai, Hong Kong, Beijing, Mexico City, Singapore, Salt Lake City, Sydney, Dubai, Madrid, Milan, Calgary, Melbourne, Auckland, Seoul, Tokyo, Taipei, Moscow, Tel-Aviv, Toronto, and Monaco.

Goldman Sachs acts as a financial advisor to some of the most important companies, largest governments, and wealthiest families in the world. It is a primary dealer in the U.S. Treasury securities market. It offers its clients mergers & acquisitions advisory, provides underwriting services, engages in proprietary trading, invests in private equity deals, and also manages the wealth of affluent individuals and families. Although its size and strength would need greater responsibility in its acts, facts revealed that it could make considerable mistakes.

Goldman Sachs, which enjoyed enormous economic success in the 1990s, was accused of "laddering" initial public offerings. IPO laddering occurs when particular clients share in an IPO before it is made public with the agreement that the client will buy a predetermined amount of additional shares once the stock hits the market. By purchasing extra shares, they made the stock look desirable and attract more investors. The privileged clients then marked up their stock and turned a bigger profit while honest investors watched their investments decline in value.

Goldman Sachs was one of five securities firms to be fined in 2002 by the SEC for improper documentation of email records, and it was also one of the ten firms involved in another case

filed by the SEC that deals with conflicts of interest between the analysis and investment banking branches of securities firms. Goldman Sachs and the other firms agreed to pay large fines to the SEC.

Of all the cases enunciated above, only one conclusion could be brought up to light: unethical treatment of clients, unfairness and injustice sooner or later lead to damages, those ranging from reputation deterioration, loss of credibility to financial losses and legal problems.

2.3 Banque BEMO, a “bank with ethics”

Banque Europeenne pour le Moyen Orient S.A.L. (BEMO) is one of the few private banks in Lebanon whose primary focus is on trade finance, on corporate and private banking and with activities covering mostly Lebanon, Cyprus and Syria and selective cities in neighboring Arab countries. The bank was first established in 1964 under the name of Future Bank and then was renamed BEMO after the shareholders took control in mid-1994. Major shareholders include the Obegi Group whose long experience in banking witnessed the foundation of one of Lebanon's largest banks, Credit Libanais, and in 1973, Banque de l'Europe Meridionale. It is also the sister company of BEMO Europe which has offices and operations in Brussels, Paris, and Luxembourg. It is a major shareholder of joint ventures with Saudi Fransi Bank, in Syria, the Banque BEMO Saudi Fransi (BBSF) and with Oddo, in Dubai, BEMO Oddo.

Financial stability

A quick overview on the financial stability of the bank would be most relevant to assist in getting to know BEMO identity. Banque BEMO is a conservative bank that has a considerable level of liquidity. Net Liquid Assets to deposits have historically been maintained in the range of 70% with 44% of its clients deposits mainly placed with prime international Financial Institutions.

The bank's policy is to maintain a minimal exposure on local sovereign risk, mainly due to the fact that management follows a conservative approach in respect of currencies mismatching between assets and liabilities, knowing that deposits in LBP represent only 6% of total.

Banque BEMO's balance sheet has recorded a continuous growth since the bank's establishment.

Its main source of funds is from customers' deposits, which currently constitutes 76.9% of the bank's total Liabilities. 77.8% represent time deposits.

"Palette" of services

Banque BEMO has established itself as one of the leading providers of private and corporate banking services in Lebanon and the Arab world. For many years, the Banque BEMO Group has demonstrated clear commitment for building long-term business partnerships based on a professional approach. Driven by a strategy for organic growth along with regional dimensions and enhanced conservative profile, Banque BEMO's centers are its Private and Corporate Banking Services. BEMO characterize its strengths as being its Relationship Managers. Those offer customers personal access to a solid base of know-how and systems to optimize their value chain and add the required scope for business growth. They provide personalized services to customers with a sophisticated and innovative financing structure that offers relevant solutions that match customer needs. BEMO's challenge is to provide its clientele with a diverse and comprehensive solution that is tailored to meet their requirements during both prosperous and difficult periods.

Its Key Success Factor is the commitment of its Board and its General Management. The loyalty of its customers, along with the benefits drawn, proves the added value from its long established customers' relationships. The main services Banque BEMO offers are Personal Banking, Corporate Banking, Financial Advisory, Treasury & Capital Markets, and Fiduciary & Trust.

The Corporate Banking Division offers a wide range of traditional and structured products and services tailored to help clients manage all their banking needs. Based on relationship banking mixed with innovative ideas, BEMO Corporate Banking team works closely with clients to understand their business needs and develop practical, cost-effective solutions. For instance, based on clients requirements BEMO designs a customized solution, by mostly arranging the lending structure that is suitable for their business whether it be for a short or long-term period. Relationship Managers and product specialists provide them with the best currency exposure structure customized to their needs while ensuring minimum risk exposure. Also, by building on the expertise and professionalism of a dedicated team of Corporate Relationship Managers,

sophisticated structured finance deals for alternative sources for liquidity are made available. Moreover, BEMO has the advantage of supporting its clients with the assistance of its affiliate BEMO Securitization SAL, the latter being recognized through several international awards.

Other typical services of BEMO's are its Family Office program, and its Arab Investors Help Desk.

Banque BEMO's Family Office in coordination with BEMO Europe - Banque Privée, caters to the needs of multi-generational families, providing them with the resources and support to help them centralize and control the management of their wealth and family affairs. In this framework, BEMO performs four main functions:

- Help clients put in place the necessary structures to define their family's objectives.
- Coordinate various financial advisory services such as legal, fiscal and accounting.
- Centralize all information to facilitate investment monitoring and evaluation.
- Maintain confidentiality of all information.

As for BEMO's Arab Investors Help Desk, it enables Arab visitors to follow up on their investment portfolios from a dedicated space at Banque BEMO, Lebanon. This service is managed by a reliable team of professionals and is equipped to monitor global capital markets with particular attention to those of Saudi Arabia and other GCC countries. Also, a range of services such as fiscal, legal, real estate, and lifestyle management is available.

Finally, along with the Personal Banking division, which offers General Banking and Network Services; and the Treasury & Capital Markets Unit, which offers innovative and integrated Foreign Exchange solutions; its Financial Advisory Unit puts forward investment advisory, brokerage and networking services, and access to investment funds, hedge funds, and structured products.

BEMO Financial Advisory Unit

BEMO Private Banking clients regularly set the most demanding goals and expect the highest standards of discretion, objectivity and professionalism from their financial advisors. They are

looking for specialists they can depend on, specialists who can deliver measurable results. This is the reason why they are referred to BEMO Private Banking. They are promised to enjoy the advantage of having a personal Financial Advisor, the latter being described as a financial partner who can discretely advise them on balancing their overall wealth management strategy while respecting their risk appetite and financial preferences. Once this broad strategic framework has been agreed upon, the financial advisor keeps them abreast of the performance of their portfolio and - if they desire - of any significant financial or economic developments that affect it. BEMO Financial Advisors are to be available for consultation at all times and must continuously monitor clients' holdings and fine-tune their financial strategy to meet their changing needs.

Since BEMO's primary tool towards providing its clients with full satisfaction is its Relationship Banking structure, Financial Advisors form the pillar of its strategy. At all times, they should assess and understand customer needs, provide them with advice on their business needs, help them find viable financial solutions for their business problems, and act as their primary contact. Furthermore, BEMO always focuses on its motto: "BEMO, a bank with ethics"

2.4 Ethics theories

Although there are no directly linked researches previously made on this topic, or at least that have been made publicly available, and since financial advisory ethics are quite relevant to business ethics in general, the main theories related to businesses' attitudes towards ethics would be very pertinent at this stage. We will therefore discuss ethics theories, and then narrow the conversation by focusing on ethical problems that financial advisory is mostly familiar with.

From the utilitarian point of view, the right course of action is the one that would have the most beneficial consequences. This approach is sometimes referred to as a *consequentialist* approach and sometimes as a *utilitarian* approach. In any situation, the "right" action or policy is the one that will produce the greatest net benefits or the lowest net costs (when all alternatives have only net costs). The problem lies in the fact that it is often calculated in monetary terms, whereas the benefits of an action may include any desirable goods (pleasures, health, satisfactions, knowledge, happiness) produced by the action, and costs may include any of its undesirable evils

(e.g. pain), hence having a qualitative aspect. Therefore, Utilitarians use the inclusive term “utility” to refer to the net benefits of any sort produced by an action.

Several government agencies, many legal theorists, numerous moralists, and a variety of business analysts advocate utilitarianism. For decades now, many business analysts have held that the best way to evaluate the ethical propriety of a business decision-or any other decision-is by relying on utilitarian cost-benefit analysis. The socially responsible course for a business to take is the one that will produce the greatest net benefits for society or impose the lowest net costs.

Traditional Utilitarianism

Jeremy Bentham (1748-1832) is generally considered the founder of traditional utilitarianism. Bentham sought an objective basis for making value judgments that would provide a common and publicly acceptable norm for determining social policy and social legislation. The most promising way to reach such an objective ground of agreement, he believed, is by looking at the various policies a legislature could enact and comparing the beneficial and harmful consequences of each. The right course of action from an ethical point of view would be to choose the policy that would produce the greatest amount of utility. Summarized, the utilitarian principle holds that an action is right from an ethical point of view if and only if the sum total of utilities produced by that act is greater than the sum total of utilities produced by any other act the agent could have performed in its place.

The utilitarian principle assumes that we can somehow measure and add the quantities of benefits produced by an action and subtract from them the measured quantities of harm the action will have and thereby determine which action produces the greatest total benefits or the lowest total costs. That is, the principle assumes that all the benefits and costs of an action can be measured on a common numerical scale and then added or subtracted from each other. Formulae would include positive and negative units of utility, and the action assessment would be based on the resulting total combined utility of this act.

Relating the theory to our case, we should not understand that the utilitarian principle says that because the right action for a particular occasion is the one that produces more utility than any other possible action, that it means that the right action is the one that produces the most utility

for the person performing the action, i.e. the financial advisor/trader. Rather, we should conclude that an action is right if it produces the most utility for *all* persons affected by the action (including the client). Also, the utilitarian principle does not say that an action is right so long as its benefits outweigh its costs. Rather, utilitarianism holds that, in the final analysis, only one action is right: that one action whose net benefits are greatest by comparison to the net benefits of all other possible alternatives.

Another misunderstanding is to think that the utilitarian principle requires us to consider only the direct and immediate consequences of our actions. Instead, both the immediate and all foreseeable future costs and benefits that each alternative will provide for each individual must be taken into account, as well as any significant indirect effects.

Consequently, to determine how one should behave on a particular occasion, he must do three things.

- First, he must determine what alternative actions or policies are available to him on that occasion.
- Second, for each alternative action, he must estimate the direct and indirect benefits and costs that the action will probably produce for each and every person affected by the action in the foreseeable future.
- Third, the alternative that produces the greatest sum total of utility must be chosen as the ethically appropriate course of action.

Utilitarianism matches fairly nicely the views that banks' management tend to advocate when discussing the choice of transactions policies and portfolio management. Most traders agree, for example, that when the management is trying to determine which transaction policy it should adopt, the proper course of action would be for it to adopt those policies that would enable the traders to reach easily their target budgets, taking into consideration clients' interests, or stated differently, that would result in the greatest measurable utility for people or, those that will produce "the greatest good for the greatest number."

Utilitarianism also seems to fit in rather neatly with the intuitive criteria that people employ when discussing moral conduct. Indeed, it discusses the benefits or harms the action will impose on human beings. However, the morality requires that one *impartially* take everyone's interest equally into account. Utilitarianism meets this requirement insofar as it takes into account the effects actions have on everyone and insofar as it requires one to impartially choose the action with the greatest net utility regardless of who gets the benefits; consequently the problem remains on the ground where the same sum of utility is reachable in two ways, and where each way favors one's account instead of the other's. In such cases, conflict of interest could arise.

Whereas utilitarianism has the advantage of being able to explain why we hold that certain types of activities are *generally* morally wrong (lying, adultery, killing) while others are generally morally right (telling the truth, fidelity, keeping one's promises), traditional utilitarians deny that any kinds of actions are *always* right or always wrong. The utilitarian can say that lying is generally wrong because of the costly effects lying has on our human welfare. When people lie to each other, they are less apt to trust each other and cooperate with each other. The less trust and cooperation, the more our welfare declines. But, for instance, they deny that dishonesty or theft is necessarily always wrong. If in a certain situation more good consequences would flow from being dishonest than from any other act a person could perform in that situation, then, according to traditional utilitarian theory, dishonesty would be morally right in that particular situation.

Utilitarianism and Economics

Another interesting aspect of utilitarianism is that utilitarian views have been highly influential in economics. A long line of economists, beginning in the 19th century, argued that economic behavior could be explained by assuming that human beings always attempt to maximize their utility and that the utilities of commodities can be measured by the prices people are willing to pay for them. With these and a few other simplifying assumptions (such as the use of indifference curves), economists were able to derive the familiar supply and demand curves of sellers and buyers in markets and explain why prices in a perfectly competitive market gravitate toward an equilibrium. More important, economists were also able to demonstrate that a system of perfectly competitive markets would lead to a use of resources and price variations that would enable consumers to maximize their utility (defined in terms of Pareto optimality) through their

purchases. On utilitarian grounds, therefore, these economists concluded that such a system of markets is better than any other alternative.

Utilitarianism is also the basis of the techniques of economic “cost-benefit analysis”. This type of analysis is used to determine the desirability of investing in a project (such as a dam, factory, or public park) by figuring whether its present and future economic benefits outweigh its present and future economic costs. To calculate these costs and benefits, discounted monetary prices are estimated for all the effects the project will have on the present and future environment and on present and future populations. If the monetary benefits of a certain public project exceed the monetary costs, and if the excess is greater than the excess produced by any other feasible project, then the project should be undertaken. In this form of utilitarianism, the concept of utility is restricted to monetarily measurable economic costs and benefits.

Lastly, we can note that utilitarianism fits nicely with a value that many people prize: efficiency. Efficiency can mean different things to different people, but for many it means operating in such a way that one produces the most one can with the resources at hand. That is, an efficient operation is one that produces a desired output with the lowest resource input. Such efficiency is precisely what utilitarianism advocates because it holds that one should always adopt the course of action that will produce the greatest benefits at the lowest cost. If we read "desired output" in the place of "benefits" and "resource input" in place of "cost," utilitarianism implies that the right course of action is always the most efficient one.

Although utilitarianism seems to be the ideal theory to adequate business relationships, there have been objections to utilitarian assumptions:

- Measurement objections: especially in cases where utility does not have a single quantifiable component.
- Incoherence with rights concepts: some utilitarian principles imply that certain actions are morally right when in fact, they violate people's rights. Hidden churning (cf. 2.3) could lead to higher gains to the client, and higher commissions for the trader at the same time, but by the fact of being hidden, it represents a violation of clients rights

- Incompatibility with justice concepts: A trader lets client 1 sell to client 2 a certain number of Z- Co. shares. The trader recommended to the latter these shares because he knows that Z- Company is going to make huge profits. Although client 1 earns a decent return by selling at a better price than he expected, it is unfair! Should have client known that these shares were going to rise in price, he would have preferred to wait. This case often happens in situations where client 1 is a preferential client - paying lower commissions' rate- and client 2 is a standard client.

Rights and duties

Whereas banks ultimate goal is profit making, we should never forget that this profit is made thanks to the liquidity provided by clients. Consequently, and as the financial institutions possess legal rights to enter into trades, clients are entitled to have their legal, but also moral rights respected. Of utmost importance, it is to be remembered that Moral Rights are tightly correlated with duties, that they aim to provide individuals with autonomy and equality in the free pursuit of their interests, and that they should provide a basis for justifying one's actions and for invoking the protection or aid of others.

In general, a right is an individual's entitlement to something. A person has a right when that person is entitled to act in a certain way or is entitled to have others act in a certain way toward him or her. The entitlement may derive from a legal system that permits or empowers the person to act in a specified way or that requires others to act in certain ways toward that person; the entitlement is then called a "legal right".

Entitlements can also derive from a system of moral standards independently of any particular legal system. *Moral Rights* or *Human Rights* are based on moral norms and principles that specify that all human beings are permitted or empowered to do something or are entitled to have something done for them. Moral rights, unlike legal rights, are usually thought of as being universal insofar as they are rights that all human beings of every nationality possess to an equal extent simply by virtue of being human beings.

The main purpose of rights is to enable the individual to choose freely whether to pursue certain interests or activities and to protect those choices. Generally, the term "right" is used to cover a variety of situations in which individuals are enabled to make such choices in very different

ways. First, it is used to indicate the mere absence of prohibitions against pursuing some interest or activity. For example, a trader has a right to do whatever the law or morality does not positively forbid him to do. In this weak sense of a right, the enabling and protective aspects are minimal. Second, it can be used to indicate that a person is authorized or empowered to do something either to secure the interests of others or to secure one's interests. Third, the term *right* is sometimes used to indicate the existence of prohibitions or requirements on others that enable the individual to pursue certain interests or activities.

The most important moral rights are rights that impose prohibitions or requirements on others and that thereby enable individuals to choose freely whether to pursue certain interests or activities. These moral rights identify those activities or interests that the individual is empowered to pursue, or must be left free to pursue, or must be helped to pursue, as the individual chooses; and they protect the individual's pursuit of those interests and activities within the boundaries specified by the rights. These kinds of moral rights have three important features that define these enabling and protective functions.

- First, moral rights are tightly correlated with duties. This is because one person's moral right generally can be defined—at least partially—in terms of the moral duties other people have toward that person. To have a moral right necessarily implies that others have certain duties toward the bearer of that right.
- Second, moral rights provide individuals with autonomy and equality in the free pursuit of their interests. That is, a right identifies activities or interests that people must be left free to pursue or not pursue as they choose (or must be helped to pursue as they freely choose) and whose pursuit must not be subordinated to the interests of others except for special and exceptionally weighty reasons.
- Third, moral rights provide a basis for justifying one's actions and for invoking the protection or aid of others. If one has a moral right to do something, then he has a moral justification for doing it. Moreover, if he has a right to do something, then others have no justification for interfering with him. On the contrary, others are justified in restraining any persons who try to prevent him from exercising his right (e.g. management), or others may have a duty to aid him in exercising his right. When a stronger person (here,

the financial advisor) helps a weaker one (here, the client) defend his or her rights, for example, management should generally acknowledge that the act of the stronger person was justified, and should encourage the recurrence of such acts. It could for instance lower pressures on the budget making, and reward performance.

Because moral rights have these three features, they provide bases for making moral judgments which differ substantially from utilitarian standards. First, moral rights express the requirements of morality from the point of view of the *individual*, whereas utilitarianism expresses the requirements of morality from the point of view of *society as a whole*. Moral standards concerned with rights indicate what is due to the individual from others, promote the individual's welfare, and protect the individual's choices against encroachment by society. Utilitarian standards promote society's aggregate utility, and they are indifferent to the individual's welfare except insofar as it affects this social aggregate. Second, rights limit the validity of appeals to social benefits and to numbers. That is, if a person has a right to do something, then it is wrong for anyone to interfere, although a large number of people might gain much more utility from such interference. If clients have a right to trade, for example, then it is morally wrong for his financial advisor to churn his account even if he would gain much more from such a behavior.

Although rights generally override utilitarian standards, they are not immune from all utilitarian considerations: If the utilitarian benefits or losses imposed on society become great enough, they might be sufficient to breach the protective walls the right sets up around a person's freedom to pursue his individual interests. In times of war or major public emergencies, for example, it is generally acknowledged that clients rights to exchange Lebanese Pounds into US Dollars may legitimately be restricted for the sake of the Lebanese Central Bank "survival".

Should we compare the two above stated theories, they shape and give to business ethics different meanings and implementation ways. The more important the interest protected by a right, the larger the utilitarian trade-offs must be: Rights erect higher walls around more important interests, and so the level of social benefits or costs needed to breach the walls must be greater. Although this memoir advocates moral rights and high standard business ethics, it also aims at depicting the benefits of combining contractual rights and duties with moral rights.

Contractual rights and duties

Contractual rights and duties (sometimes called *special rights and duties* or *special obligations*) are the limited rights and correlative duties that arise when one person enters an agreement with another person. The client acquires a contractual *right* to whatever the bank promised, and the bank has a contractual *duty* to perform as it promised.

Contractual rights and duties are distinguished, first, by the fact that they attach to *specific* individuals and the correlative duties are imposed only on other *specific* individuals. Second, contractual rights arise out of a specific transaction between particular individuals. Unless the bank actually makes a promise or enters arrangement with the client, the client –legally- does not acquire any contractual rights over the bank. Third, contractual rights and duties depend on a publicly accepted system of rules that define the transactions that give rise to those rights and duties. So, to be able to build high ethical standards, a bank should have in its employment contract, as in the client “opening of account” contract, a specific code of ethics in the former, and a list of agreements made with the client in the latter.

Should there be no code of ethics; the bank could refer to general ideals revolving around moral rights, ethic of care, and/or justice and fairness concepts.

A Basis for Moral Rights: Kant

A person has certain legal rights because the person lives within a legal system that guarantees those rights. However, what is the basis of moral rights?

Utilitarians have suggested that utilitarian principles can provide a satisfactory basis for moral rights: People have moral rights because the possession of moral rights maximizes utility. It is doubtful, however, that utilitarianism can serve as an adequate basis for moral rights. To say that someone has a moral right to do something is to say that person is entitled to do it regardless of the utilitarian benefits it provides for others. Utilitarianism cannot easily support such a non-utilitarian concept.

A more satisfactory foundation for moral rights is provided by the ethical theory developed by Immanuel Kant (1724-1804). Kant in fact attempts to show that there are certain moral rights and

duties that all human beings possess regardless of any utilitarian benefits that the exercise of those rights and duties may provide for others.

Kant's theory is based on a moral principle that he called the “categorical imperative” and that requires that everyone should be treated as a free person equal to everyone else. That is, everyone has a moral right to such treatment, and everyone has the correlative duty to treat others in this way. Kant provides at least two ways of formulating this basic moral principle; each formulation serves as an explanation of the meaning of this basic moral right and correlative duty.

The First Formulation of Kant's Categorical Imperative

Kant's first formulation of the categorical imperative is as follows: "I ought never to act except in such a way that I can also will that my maxim should become a universal law." A “maxim” for Kant is the reason a person in a certain situation has for doing what he or she plans to do. A maxim would "become a universal law" if every person in a similar situation chose to do the same thing for the same reason.

An action is morally right for a person in a certain situation if, and only if, the person's reason for carrying out the action is a reason that he or she would be willing to have every person act on, in any similar situation. A person's reasons for acting, then, must be "reversible": One must be willing to have all others use those reasons even against oneself. There is an obvious similarity, then, between the categorical imperative and the so-called *golden rule*: "*Do unto others as you would have them do unto you.*" A person's reasons for acting, then, must also be universally acceptable: It must be possible, at least in principle, for everyone to act on those reasons.

The first formulation of the categorical imperative, then, incorporates two criteria for determining moral right and wrong “universalizability” and reversibility:

- “Universalizability”: The person's reasons for acting must be reasons that everyone could act on at least in principle.
- Reversibility: The person's reasons for acting must be reasons that he or she would be willing to have all others use, even as a basis of how they treat him or her.

Unlike the principle of utilitarianism, Kant's categorical imperative focuses on a person's interior motivations and not on the consequences of external actions. Moral right and wrong, according to Kantian theory, are distinguished not by what a person accomplishes, but by the reasons the person has for the action. It is thanks to this reasoning that this study will suggest that end-of-year bonuses be based on clients' portfolio performances.

Kant argues that, to the extent that a person performs an action merely because it will advance the person's own future interests or merely because the person finds the action pleasurable, the action "has no moral worth." A person's action has "moral worth" only to the degree that it is *also* motivated by a sense of "duty," that is, a belief that it is the right way for all people to behave. Therefore, Kant claims, to be motivated by a sense of "duty" is to be motivated by reasons that I wish everyone would act on. Consequently, my action has "moral worth" (i.e., it is morally right) only to the extent that it is motivated by reasons that I would be willing to have every person act on. Hence, the categorical imperative.

The Second Formulation of Kant's Categorical Imperative

"Act in such a way that you always treat humanity, whether in your own person or in the person of any other, never simply as a means, but always at the same time as an end." Or never treat people only as means, but always also as ends.

What Kant means by "treating humanity as an end" is that everyone should treat each human being as a being whose existence as a free rational person should be promoted. For Kant, this means two things: (a) Respect each person's freedom by treating people only as they have freely consented to be treated beforehand, and (b) develop each person's capacity to freely choose the aims to pursue. Consequently, a financial advisor—knowing that his client has limited knowledge of market transactions—should inform his advisee on the how's and why's, guide him and make sure he bases his orders on correct reasoning. As Kant's theory suggests, "an action is morally right for a person if, and only if, in performing the action, the person does not use others merely as a means for advancing his or her own interests, but also both respects and develops their capacity to choose freely for themselves".

The Problems encountered with Kant's theory, as some critics claim, is that, although we might be able to agree on the kinds of interests that have the status of moral rights, there is substantial

disagreement concerning what the limits of each of these rights are and concerning how each of these rights should be balanced against other conflicting rights. Although, Kant could be defended by holding that his categorical imperative is not intended to tell us how conflicting rights should be limited and adjusted to each other, the fact remains that, according to Kant's theory, if a trader was churning his client's account, while accepting to have – should he need one- his trader take advantage of his positions- the trader would be acting morally. And according to traders' rights, this is wrong because it is obviously immoral.

The Libertarian Objection: Nozick

Libertarian philosophers go beyond the general presumption that freedom from human constraint is usually good; they claim that such freedom is necessarily good and that all constraints imposed by others are necessarily evil except when needed to prevent the imposition of greater human constraints. The American philosopher Robert Nozick, for example, claims that the only basic right that every individual possesses is the negative right to be free from the coercion of other human beings. This negative right to freedom from coercion, according to Nozick, must be recognized if individuals are to be treated as distinct persons with separate lives, each of whom has an equal moral weight that may not be sacrificed for the sake of others. The only circumstance under which coercion may be exerted on a person is when it is necessary to keep that person from coercing others. Relatively to our topic, a financial advisor does not have the right to abuse his clients' trust (cf 2.3 common abuses).

Justice and Fairness

Disputes among individuals in business are often interlaced with references to *justice* or *fairness*. This is the case, for example, when a client accuses a financial advisor of unjustly charging him or her extra commissions, showing unjust treatment relatively to other clients, or not taking up a *fair* share of the burdens involved in some transactions. Resolving disputes like these requires that we compare and weigh the conflicting claims of each of the parties and strike a balance between them. Justice and fairness are essentially comparative. They are concerned with the comparative treatment given to the members of a group when benefits and burdens are distributed, when rules and laws are administered, when members of a group cooperate or

compete with each other, and when people are punished for the wrongs they have done or compensated for the wrongs they have suffered.

Standards of justice are generally taken to be more important than utilitarian considerations. If a society is unjust to some of its members, then we normally condemn that society, even if the injustices secure more utilitarian benefits for everyone.

Opponents

Some other theories would object bringing ethics into business from the start. Those argument that in perfectly competitive free markets, the pursuit of profit will by itself ensure that the members of society are served in the most socially beneficial ways; i.e. to be profitable, each bank would rather have to produce only what the investors want and has to do this by the most efficient means available. However, some pitfalls remain: first, most industrial markets are not “perfectly competitive” as the argument assumes; second, the argument assumes that any steps taken to increase profits will necessarily be socially beneficial, whereas in reality several ways of increasing profits often injure investors. Third, the argument assumes that, for instance, by selling high reward/high risk investments that are most wanted by savvy investors, the bank is accomplishing its task of meeting clients’ wants, whereas most investors’ wants are not met due to their potential dislike of such products, should they have known the risk they were incurring. Fourth, the argument is essentially making a normative judgment “managers should devote themselves to the single-minded pursuit of profits” on the basis of some assumed but unproved moral standards “people should do whatever will benefit those who participate in markets”. Thus, although the argument tries to show that ethics does not matter, it can do this only by assuming an unproved moral standard that at least appears mistaken.

Another kind of objection show that business managers should single-mindedly pursue the interests of their firms and should ignore ethical considerations, or as Alex C. Michales call, they should be “loyal agents”. The dilemma is that the law of agency (law that specifies the duties of persons who agree to act on behalf of another party and who are authorized by an agreement so to act) does not take into consideration that advisors should also act as agents of their clients and that they accept a legal and moral duty to serve them loyally, obediently, and in a confidential manner. The most important pitfall of that argument is that loyal agent’s argument assumes that

if a manager agrees to serve a firm, then this agreement automatically justifies whatever the manager does on behalf of the firm, however this assumption false! Since agreements to serve other people do not automatically justify doing wrong on their behalf.

A final objection states that business ethics is limited to obeying the law. Here the problem is that law and ethics are very different, especially by the fact that the first does not always coincide with morality.

Still, there are also arguments favoring ethics in business. First, ethics applies to human activities. Second, businesses cannot survive without ethics. Third, ethics is consistent with profit seeking. And finally, customers and employees care about ethics. We can consequently say that ethics should be brought into business simply by pointing out that, because ethics should govern all voluntary human activities and because business is a voluntary human activity, ethics should also govern business. In short, there is nothing about business that would prevent us from applying the same standards of ethics to business activities that should be applied to all voluntary human activities.

Arguments supporting that ethics should be part of business point out that business activities, like any other human activities, cannot exist unless the people involved in the business and its surrounding community adhere to some minimal standards of ethics. Business is a cooperative activity whose very existence requires ethical behavior. First, any individual business will collapse if all of its managers, employees, and customers come to think that it is morally permissible to steal from, lie to, or break their agreements with the company. Because no business can exist entirely without ethics, the pursuit of business requires at least a minimal adherence to ethics on the part of those involved in business. Second, all businesses require a stable society in which to carry on their business dealings. Yet the stability of any society requires that its members adhere to some minimal standards of ethics. In a society without ethics, as the philosopher Hobbes once wrote, distrust and unrestrained selfinterest would create "a war of every man against every man," and in such a situation life would become "nasty, brutish, and short." The impossibility of conducting business in such a society-one in which lying, theft, cheating, distrust, and unrestrained self-interested conflict became the norm-is shown by the way in which business activities break down in societies torn by strife, conflict, distrust, and civil

war. Because businesses cannot survive without ethics, then, it is in the best interests of business to promote ethical behavior both among its own members as well as within its larger society.

Another persuasive way to argue that ethics should be brought into business is by showing that ethical considerations are consistent with business pursuits, in particular with the pursuit of profit. That ethics is consistent with the pursuit of profit can be shown by simply finding examples of companies where a history of good ethics has existed side by side with a history of profitable operations. Companies that have combined a good history of profit with exemplary ethical climates include Intel, Timberland, Hewlett-Packard, Cisco Systems, Levi Strauss, Southwest Airlines, Patagonia, Procter & Gamble, and Starbucks Coffee. Although these are not financial institutions, loyalty and client retention factors are always the result of the lived experience by the clientele and of the fulfillment of its needs.

2.5 Financial Advisory and the conflict of interest

Need to implement financial reward plan based partly on clients' portfolio performance rather than solely on commissions generated from their transactions.

Unethical sales practices often lead to costly litigation, to job dismissal and possibly to career withdrawal. However, the outcome of any legally biased action is till day uncertain, because of confusion in the law. Still, the importance of ethics in financial institutions advisory has led some banks to adopt policies that give employees firm guidelines on acceptable practices and also set the tone for practices within the industry. Unfortunately, it has not been the case yet for the majority of banks. In Lebanon, for instance, it is only lately that the Central bank started obliging local financial institutions to have all financial advisors pass the United Kingdom Financial Services Authorities' exams, and even in that matter, some banks have not started applying the rules.

Even if financial institutions started to have stricter educational requirements, the desired shift in financial advisors ethics could not be complete without complementary code of ethics and specific policies on conflict of interest. Conflict of interest occurs when a personal interest comes into conflict with an obligation to serve the interests of another. In our case, its occurrence is

highly probable, as financial advisors personal interest to reach budget interferes with their duty to promote their client's interests. Since this kind of obligation characterizes an agency relation, in which one person – agent, the Financial Advisor – agrees to act on behalf of another – the principal, here, the client, its open-endedness feature could be problematic, as there is no set of detailed duties depicting how to act, and since it is rather qualitative in nature. Consequently a particular attention to the nature of the interests to be served is to be paid, and the latter should be relevant to the principal's needs and wants.

As occurrence is highly probable, the conflict of interest we have on hand is classified as “actual”. Actual conflict of interest, refers to a personal interest leading the agent to act against the interests of the principal, whereas a “potential” conflict of interest refers to a situation where there is a little possibility that the agent will fail to fulfill an obligation to act in the principal interests.

Another classification of the possible conflict of interest encountered by financial advisors is whether this conflict is personal or impersonal. This differentiation is often neglected, although it is relevant to note that these agents are frequently engaged into “personal” *and* “impersonal” conflict of interest. Their personal interest comes into conflict with the interests of their clients, considering the need to close the budget while picking the right investments; as their impersonal interest do, since they are obliged to reach target in the company's interest while remaining reasonable advisors. There is therefore solid ground to believe that this kind of agency relationship tend to face considerable conflicts of interests. Factors enhancing the likelihood of aggravation of conflict of interests include:

- *The potential of providing biased judgment*: In the financial advisory profession, the exercise of judgment is redundant. Providing a good judgment is crucial as financial advisors are paid for using their knowledge to make judgments for the benefit of their clients but also part of the value of their services lies in the confidence that can be placed in their professional judgment
- *The inherent risk of misusing position*: holding a position of discretionary account manager gives the financial advisor powers and opportunities that would not be available otherwise, like advising a conservative client on highly volatile products, misrepresenting product specifications, or using the fact to be the sole advisor to recommend inappropriate transactions.

As mentioned earlier, as budget making practices become increasingly relentless (including peer pressure, pressure to conform), it is high time we started clarifying what are the acceptable practices while advising clients on portfolio transactions. As this includes greater accountability, responsibility taking will be examined at the different levels of advisory on investment. Procedural modifications aiming at determining clients' investor's profiles will follow.

Chapter 3 Ethical Dilemma of Financial Institutions

If we analyze the ethics of the financial institutions, we notice that it has been due to their absence (ethics') –as much at the macroeconomic level as at the micro one-, that we ended up thrown in many crises. As a point of reference, the following chapter depicts the unethical behaviors of major actors in the financial arena, while showing the pathway of the subprime troubled assets.

3.1 The Subprime Mortgage Crisis

Mortgages loans are a common service in North America. In 2007, more than six million people in the United States who had no money had been able to borrow about 100% of the value of a house. These were identified as “subprime borrowers”. The excessive borrowing happened when the housing markets in the United States were at their higher performances, and since then these markets' performances had steeply declined.

The problem was at the lending stage. The more the property boom was amplifying, the more lax the rules for lending became. Property seemed like a one way bet and therefore lenders could charge poor credit risk customers more interest and fees securing mortgages. Furthermore, in case of default, the lenders assumed that they could foreclose and sell the property at a profit. Thus, there was little perceived risk in the marketplace.

Sources of funds

But where did these lenders find their sources of funds? As the world was awash with cheap money, due to historically low interest rates, lenders were able to borrow at low interest rates and loan out at much higher interest rates. In the lending financial sector, commercial banks were being able to borrow from their central banks by lending out many times the amount they had on

deposit with the latter. This was a typical case of money printing. Money supply grew, and most of it went into loans of subprime risk.

Also, the Yen Carry Trade boosted this growth. Japan, for export purposes –mainly towards the US-, kept on printing money and on maintaining its interest rate low so as to keep its currency low. This in turn enables financial institutions to borrow in Yen at low interest rates and lend those to those of subprime risk at much higher interest rates.

The bubble burst

As the US market was roaring ahead, most participants tended to be carried away with themselves in terms of debt taken on and expectations of future growth. During 2005 and 2006, lenders were almost disputing places to lend money to even poorer risk borrowers so as to benefit from the extra return. The bubble burst when subprime borrowers, having saddled themselves with debt, started to find difficulties in servicing the latter even at low interest. The crisis then started when interest rates started to rise.

Money supply growth

As money supply grew over the last 4 years, most assets prices increased. Commodities were among those. Production and speculative demand took off, in such a way that even the cheap Chinese goods started to face inflationary pressure. Global inflation increased and so did interest rates in western economies.

	Early 2004	2007
US	1%	5.25%
	October 2003	2007
UK	3.5%	5.75%
	November 2005	2007
Europe	2%	4%

Table 1: Average Market Interest Rates
Source: Reuters

The credit crunch occurred when poor credit borrowers were in increasingly numbers unable to meet the higher debt repayments; and were being foreclosed. Concerning the Yen speculators, those who borrowed it at low interest rate and invested the sum in subprime mortgage sector, they only needed the Japanese currency to remain weak and its relative interest rate low. However, in February 2007, the opposite happened. As the Yen increased, debts followed. Lenders rushed to liquidate Yen carry trade positions, which made it worse since global liquidity began to vanish. Outflows from stock markets peaked and a squeeze on mortgage lending resulted. Subprime mortgage market was already in meltdown as losses were being realized through foreclosures.

If we are to inspect the chronological causes of the subprime mortgage market meltdown, it is of value to study how the mortgage deals arrived to this precarious level.

3.2 Pre-structure phase

3.2.1 Predatory lending

In the loan industry, many federal agencies use the term “Predatory lending” as a catch-all term for various specific illegal activities. Predatory lending consists of a lender practice to deceptively convince borrowers to agree to unfair and abusive loan terms, or to systematically violate those terms in ways that make it difficult for the borrower to defend themselves. An example of such practices includes lending on unreasonably high interest rates. It can also occur on loans backed by some kind of collateral, such as a car or house, so that if the borrower defaults on the loan, the lender can repossess or foreclose the collateralized asset, then profit by selling it.

Subprime lenders

There is a great deal of dispute between lenders and consumer groups as to what exactly constitutes "unfair" or "predatory" practices, but the following are most often cited.

Risk-based pricing: Risk-based pricing is the practice of charging more the borrowers (in the form of higher interest rates and fees) for extending credit to them, whenever the lenders consider them to be posing a greater credit risk. The lending industry argues that risk-based pricing is a legitimate practice, for the simple reason that a greater percentage of loans made to less creditworthy borrowers can be expected to go into default, consequently, higher prices are necessary to obtain the same yield on the portfolio as a whole. Still, some consumer groups argue that higher prices paid by more vulnerable consumers cannot always be justified by increased credit risk.

Servicing agent and securitization abuses.

The servicing agent is the entity that receives the mortgage payment, keeps the payment records, provides borrowers with account statements, imposes late charges when the payment is late, and pursues delinquent borrowers. A securitization is a financial transaction in which assets, especially debt instruments, are pooled and securities representing interests in the pool are issued. Most loans are subject to being bundled and sold, and the rights to act as servicing agent sold, without the consent of the borrower. Although a federal statute requires notice to the borrower of a change in servicing agent, it does not protect the borrower from being held delinquent on the note for payments made to the servicing agent who fails to forward the payments to the owner of the note. The problem occurs in cases where that servicing agent goes bankrupt. Borrowers who have made all payments on time can find themselves being foreclosed on and might become unsecured creditors of the servicing agent. In some states -Texas, for instance- there is no defense against eviction. The borrower ends up being forced to move and incur the expenses of hiring a lawyer and finding another place to live, while litigating the claim of the "new owner" to own the house. This especially happens after the note is resold one or more times. When the debtor demands that the current claimed note owner produce the original note with his signature on it, the note owner typically is unable or unwilling to do so, and tries to establish his claim with an affidavit that it is the owner, without proving it is the "holder in due course", the traditional standard for a debt claim, and the courts often allow them to do that. In the meantime, the note continues to be traded, its physical whereabouts difficult to discover.

It goes without saying that predatory lending is an unfair, hence unethical, credit practice, since it does harm the borrower and does often supports a credit system that promotes inequality and

poverty. By placing borrowers into higher interest rates loans than what their credit risk calls for, financial services companies end up padding their profit margins by draining away the equity borrowers have built in their homes over years. These same borrowers could have been eligible for a loan in the “prime” market, but were channeled into more expensive loans in the “subprime” market. The flagrant unfairness is that studies made by the HUD (the Housing and Urban Development Federal Agency, responsible for encouraging housing Development) have showed that, since 1994, conventional, prime lending to black and Hispanic borrowers has dropped, that black borrowers are increasingly being turned down for prime rate loans in numbers that far outstrip whites, and that lending by subprime companies to minorities is on the rise.

The factor that aggravated this gap is the fact that unless a company was proved to be discriminating a minority of a group, the elderly, or others protected by laws, it could engage in predatory lending without facing legal accusations. Another boosting factor is the rapid changes undergone by the home mortgage market: Banks, which happen to be the suppliers of lower interest “prime” market, have issued a declining share of home mortgages over the past years, while the subprime market kept on booming. As a result, homeowners started to borrow against their houses to consolidate debt, going to the extent of mixing consumer finance (traditional credit cards services and home improvement loans) with home mortgages.

In the next section, we will examine how other key players interfere in the predatory lending, mainly, the mortgage brokers and the credit life insurance. But for now, it is worth noting that although subprime lending can be fair when justified, i.e. when higher credit risks are charged higher interests on loans, its growth relatively to minorities, when coupled with the decrease in prime lending, leads to concerns that minority borrowers with good credit are being denied the right for conventional loan markets and channeled instead into more expensive, subprime loans. For instance, figures found in Freddie Mac and Standard and Poor’s reports indicate that around 63% of subprime borrowers, in 2006-2007, could have had qualified for conventional “A” or “A-” quality loans.

Furthermore, justification to higher interests on subprime loans can be achieved and profitable, without having the need to engage in predatory practices. Consequently, it is in the favor of the

financial markets health to increase borrowers' protection, for example, via the enhancement of consumer protection laws.

Mortgage Brokers

A study showed that mortgage brokers originated on average over 50 percent of subprime loans in the years 2006-2007. Those used to make money in the same way prime-rate brokers did: by charging the customers a fee for finding a loan, but also, by adding a "yield-spread premium": an additional interest percentage from the one paid to the lender.

Mortgage brokers are hence considered to have been predatory lenders, for they often aggressively marketed to moderate-income and minority communities, through mail, phone, TV, and even door-to-door sales. Their Key Success Factor was that in their advertisements, they used to promise lower monthly payments as a way out of debt. The ethical issue was that they used to forget to mention to potential borrowers that they were going to be paying more and longer, and that they were on the edge on entering a system that promoted a cycle of debt, i.e. an economic system that is unequal and unfair.

Besides, a major worry is that these same brokers needed only to register with the state without taking a licensing exam or showing any proof of training. As a result, a mortgage broker that violated lending laws could simply close shop and re-open under a different name.

Credit Life Insurance Companies

Another accomplice in the unfair lending is the Credit Life Insurance companies. Although it is logical that mortgage brokers hedge their risk by including a Credit Life Insurance company in the subprime loans contract, there is serious questioning on how this element should be revealed (to the borrower). Very often, these are slipped in the credit file, and are described with great opacity to the borrower. They are sometimes quasi-hidden. Additionally, the fact that these are going to be paid back over the whole loan term, while they only cover a part of it, is very common.

E.g: Mr. X did not want to include a credit life insurance in its credit file. He ended up buying, without his notice, that policy that was good for the next 5 years, although the loan was over the next 30 years. Besides, since his mortgage broker knew how to "make the deal", the policy price

settlement was echeloned over the whole period. Mr. Green ended up paying for 30 years more than the double of the policy fair price, for a policy that was going to last him only 5 years.

Financial service companies often offer credit insurance that is financed over time to lower the monthly payments on the premium. This increases the cost of the policy, since it adds high interest rates and financing fees to the premium. The financing usually takes equity from the home to pay the insurance premium. It is therefore only normal to think that these should be carefully studied and hand-picked among a pool in order to offer competitive insurance products. Unfortunately, lenders do not offer a range to choose from because they often own or affiliate with a credit insurance company whose product they offer. Consequently, the offered insurance is very often more expensive than other types of insurance, while providing lower benefits. To add to the list is the fact that borrowers -most frequently- do not realize they bought the insurance or how much it will cost them.

Another deceptive bond in predatory lending contracts is the inclusion of penalties -added by lenders- to keep borrowers from refinancing their loans. These are usually so high that borrowers find themselves trapped into a high-rate loan because the penalties charged if they prepay the loan using a cheaper loan are so large that they cannot afford them. Without these, the subprime loans would be more difficult to sell on the secondary market.

Financial institutions typically raise more cash- to make more loans- by selling the loans they already made to the secondary market. Secondary market companies then "bundle" these loans together and sell them to insurance companies, pension plans, mutual funds, and other investors much as prime mortgages are bundled and resold. The key advantage of these bundled products is that they offer a higher rate of return than a prime-rate loan; consequently, the lender is usually able to charge more for it and make more money.

Bottom line, before the subprime loan was taken, the borrower had had built up a specific equity proportion in his home. After the loan, he had less than the quarter left. More than half of his home equity was lost due to excessive fees. He ended up paying more over the long term. His monthly mortgage payments increased. His increased debt service and loss of wealth meant he became even more vulnerable to economic shocks in the future, and more likely to lose his home through foreclosure.

In the meantime, those who profited from Mr. X's loss of wealth were the loan broker, the lender, the credit insurance company, and the secondary market, which made an extra profit on Green's loan.

3.2.2 Securitization and the Special Purpose Vehicles

After predatory lending occurs, lending financial firms, mainly banks, seek to regain a good capital adequacy ratio and solvency margins. Although this practice does not *always* absolve them from bearing the servicing/default risk, it does enable them to remove out of their balance sheets these loans. This happens via the transfer of mortgaged loans to Special Purpose Vehicles—those often being created for this purpose by the lenders.

Lenders convert mortgages into bonds called Mortgage-Backed Securities. Then, they sell these in order to escape the risk of default. However, as it is not always easy to sell a package of these MBS, credit quality must be defined. As these products' underlying are subprime, and since they are very likely to go into default, credit rating agencies end up, or at least should, give them low credit scores. Consequently, as the MBS are not considered to be investment grade, many portfolio managers do not invest in them.

It is now the turn of SPVs, or bankruptcy-remote trust to enter the arena. These trusts are an essential component of credit risk transfer, as they protect investors from the potential bankruptcy of the originator.

Special Purposes Vehicles can be used as a tool to finance projects without putting the entire firm at risk. They are also a device that allows to lower credit risk. However, they are often used to *wrongfully* hide debt. Indeed, a company could look like it had not liability whereas it really did. This is usually the case when the company is legally responsible for the SPV it created. As with the Enron bankruptcy case, it is only normal to want to avoid such practices, as their results could be devastating. The way SPVs process the pool of MBS is quite similar to investment banks procedures.

3.2.3 Investment banks

Before defining the role of investment banks in the securitization of ABS Asset Backed Securities, let us first introduce some key terms.

- Collateralized Debt Obligation: A CDO is an investment grade security backed by a pool of loans, bonds and other assets. It does not specialize in any one type of debt, and consequently represent different types of debt, maturity and credit risk.
- Collateralized Mortgage Obligation: A CMO is similar in structure to a CDO, but it is backed only by mortgages.
- Collateralized Bond Obligation: A CBO is similar in structure to a CDO and a CMO, but it is backed only by bonds.
- Asset Backed Security: A ABS is a financial security backed by a loan, lease or receivables (e.g: a company's royalties) against assets *other* than real estate and mortgage-backed securities. E.g: An ABS investor could be looking for an alternative to investing in several corporate bonds.

A company or a group of companies usually look to enhance its liquidity. One of the methods it adopts is the sale of its receivables to a bank or other conduit, which in turn will issue them to its investors as commercial papers. Investment banks, in our case, take the MBS and divide them into several pieces, mainly CDOs. They do this in order to create some higher risk assets and some safer ones. In other words, they slice up the MBS into different risk tranches:

- Equity: High risk tranche. By higher risk, higher returns are implied, hence the equity tranche earns the highest profits, but if things go wrong, it is also the first to be lost
- Mezzanine: Middle risk tranche. Moderate investors usually pick this tranche. If things go worse, after the equity tranche is lost, mezzanine is lost in turn.
- Investment grade bonds: Low risk tranche. These are the most sought after. Even in the worse case scenarios, investment grade bonds are the safest and could still be fully paid out. This persuades the credit rating agencies to qualify for the critical investment grade rating.

Through the above stated tranches, the investment banks had created a decent proportion of highly marketable bonds out of a package of low-quality mortgages. Via their sale, they had also been able to raise cash quickly and then fund fresh mortgage loans to new subprime borrowers. As investment banks prefer not to keep much of the newly created CDO's on their balance

sheets, and since their main activities are deal making and distribution, they then focused on the sale of the harder-to-sell mezzanine and equity tranches. To do so, they created hedge funds.

Hedge Funds

When the investment bank creates a hedge fund it uses some of its own capital to get the fund started. The fund purpose is to trade in the high risk equity and middle risk mezzanine CDOs, which it would have beforehand bought from the investment bank. The latter bets and hopes that the housing market then goes up, which is by the matter of fact what happened. The CDOs became safer since house prices were getting higher. Although this equity product was not traded on any open market, and therefore was not a liquid asset, the hedge fund performed amazingly well. Consequently this increasing performance attracted more investments. The hedge fund started to leverage its risk by contacting unrelated lending banks to borrow money from them while using its high performing but illiquid CDO equity as collateral.

By getting help from the initiating investment bank, the hedge fund had been able to mark up the value of its equity CDOs on the basis of rising house prices. The lending bank seeing its collateral becoming safer started to lend even more cash against it to the hedge fund. So the money lent by the bank against the CDO equity is used by the hedge fund to buy more CDOs from the investment bank, which buys more MBS from the mortgage lender, which provides more money to some prime borrowers. Those then buy more houses, pushing real estate prices higher again.

Its goes without saying that trouble could only but start as house prices turned sharply down. The lending bank asked for its money back but the hedge fund did not have any anymore. So the collateral needed to be sold but, since it was highly risk dense the equity slice lost value without ever being bought or sold in an open exchange.

As marking down a paper price in such circumstances is incredibly harmful for the investment bank it kept on delaying its decision to do so. That is exactly what cost it the evasion of clients. Banks got stuck with unsellable CDOs, and as they were/are forced to “cover their bets” by making provisions for bad debts, they started indirectly withdrawing liquidity from the market place and making it more difficult for the whole group of borrowers to find credit. The result was a credit squeeze and the beginning of today’s recession.

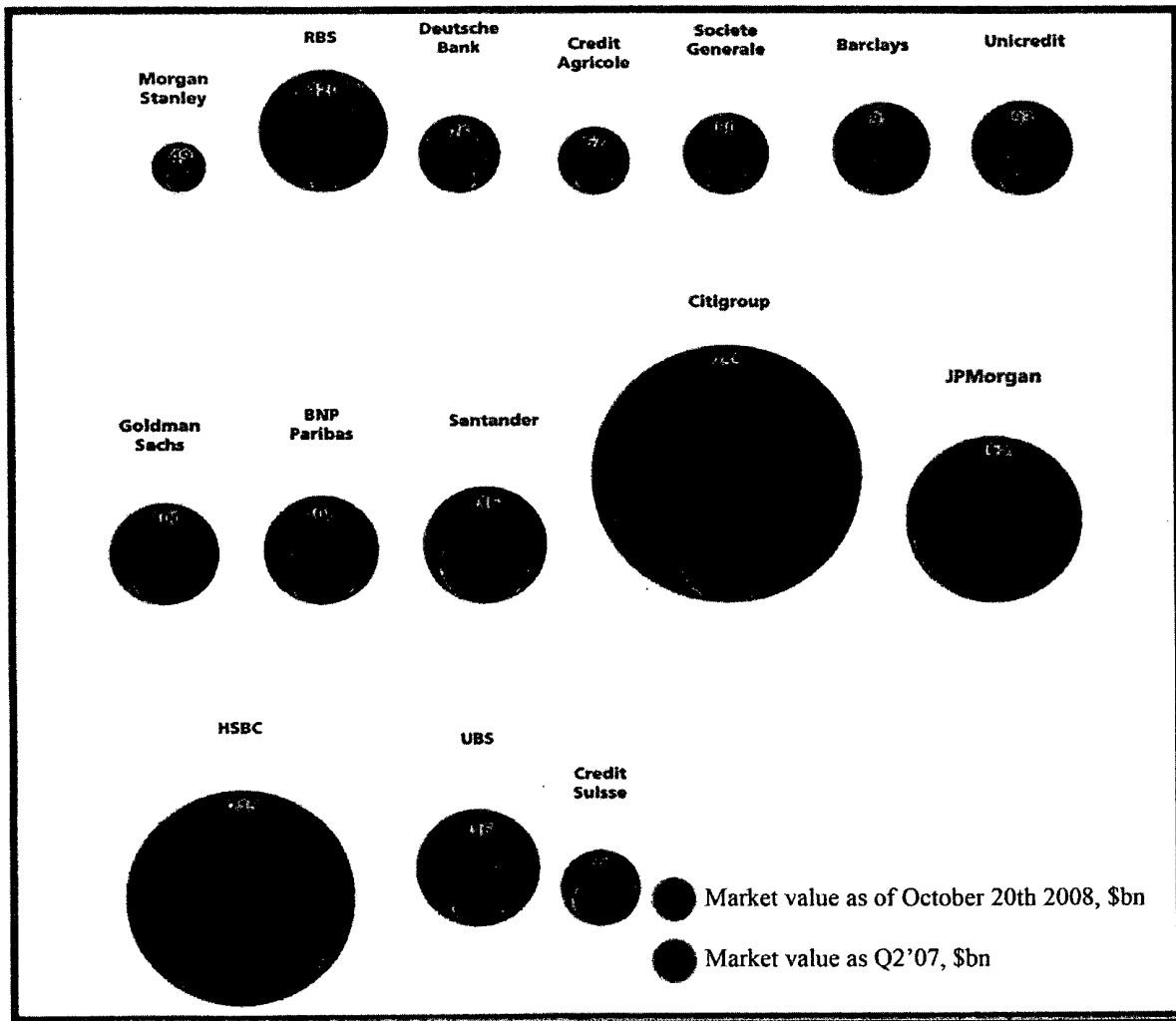


Figure 1: Banks Market Capitalizations
 Source: Bloomberg, October 2008

#	By Bank	Total Equity 2H2008 (US\$bn)	Loss (US\$bn)	Capital Raised (US\$bn)	Job Cuts
1	Citigroup Inc	136.4	85.1	71.1	14,074
2	Merrill Lynch	34.8	52.2	29.9	5,220
3	Washington Mutual Inc	30.0	45.6	12.1	4,200
4	UBS AG	51.2	44.2	28.1	7,000
5	HSBC Holdings Plc	134.0	27.4	5.1	2,750
6	Wachovia Corporation	78.2	22.7	11.0	8,393
7	Bank of America Corp	162.7	21.2	20.7	11,150
8	JP Morgan Chase & Co	133.2	18.8	19.7	4,100
9	Morgan Stanley	34.5	15.7	14.6	4,400
10	IKB Deutsche Industriebank AG	1.9	14.8	12.2	0
11	Royal Bank of Scotland Group Plc	103.7	14.2	23.2	7,200
12	Lehman Brothers Holdings Inc	26.3	13.8	13.9	13,390
13	Credit Suisse Group AG	51.8	10.4	3.0	1,565
14	Deutsche Bank AG	53.0	10.4	6.1	470
15	Wells fargo & Company	48.0	10.0	5.8	500
16	Other European Banks	n.a.	9.1	2.9	2,370
17	Credit Agricole SA	65.1	8.8	8.5	500
18	Barclays Plc	65.3	7.7	17.9	900
19	Canadian Imperial Bank	13.0	7.3	2.8	100
20	Fortis	47.9	7.1	23.1	500
21	Bayerische Landesbank	18.2	6.9	0.0	350
22	HBOS Plc	42.1	6.8	7.2	615
23	ING Groep NV	47.2	6.7	4.6	0
24	Societe Generale	63.3	6.6	9.4	0
25	Mizuho Financial Group	50.2	6.1	0.0	300
26	Other Asian Banks	n.a.	5.5	8.9	0
27	National City Corp	18.0	5.4	8.9	900
28	Natixis	24.9	5.3	11.9	850
29	Indymac Bancorp	1.5	4.9	0.0	2,800
30	Goldman Sachs Group Inc	48.5	4.9	10.6	1,500
31	Lloyds TSB Group Plc	22.1	4.7	4.8	0
32	Landesbank Baden-Wuerttemberg	13.6	4.7	0.0	0
33	WestLB AG	7.1	4.6	7.2	1,530
34	Dresdner Bank AG	14.4	3.9	0.0	1,000
35	BNP Paribas	88.3	3.9	0.0	0
36	E*Trade Financial Corp	2.6	3.6	2.4	0
37	HSH Nordbank AG	1.0	3.5	1.8	750
38	Rabobank	50.3	3.5	0.0	0
39	Nomura Holdings Inc	18.3	3.4	1.2	400
40	Bear Stearns Companies Inc *	11.9	3.2	0.0	9,159

Table 2: Banks Writedowns and Credit Losses vs. Capital Raised and Job Cuts
Source: Bloomberg, February 2008

By Region	Loss (US\$bn)	Capital Raised (US\$bn)	Job Cuts
Americas	328.7	235.4	83,770
Europe	232.7	227.6	36,350
Asia	24.2	22.2	790
TOTAL	585.6	485.2	120,910

Table 3: Banks Writedowns and Credit Losses vs. Capital Raised and Job Cuts, by region
Source: Bloomberg, February 2008

Questioning about investment banks' ethics resides, as they should have marked down paper prices much faster.

Issuer duties

As there are many, we should at least state the most important issuers' duty. Nowadays, these should show transparency, integrity and ethics.

In October 2008, the SFC, Securities and Futures Commission urged issuers of retail investment products to fulfill their risk-disclosure duties. In view of widespread public concern over the marketing of retail structured products triggered by the collapse of Lehman Brothers Holdings Inc. It issued a circular to require all issuers of retail investment products to review whether risk disclosure and product descriptions are adequate, given the current market conditions. Marketing materials issued should be "clear, fair and present a balanced picture with adequate and prominent risk disclosure in compliance with all applicable regulations". As SFC's Chief Executive Officer Mr Martin Wheatley puts it, "Recent events show that investors need to be presented with a clearer picture of product risks – they need to understand better how products will operate in extreme market conditions or in the face of bankruptcy". More diligence while exercising their duties is required.

The circular also reminded issuers to include in their marketing materials "upfront, prominent and adequate warnings" of all risks, including "new risks" emerging from prevailing market conditions.

3.3 At the structuring phase

3.3.1 Rating agencies

When a financial advisor is willing to provide a conservative client with a more or less risk-free product, he usually analyses the investment or refer to previously made analysis. In the latter, he often refers to rating assigned to the product. The problem arises when the rating itself does not meet the adequate criteria of objectivity, correctness and exactitude.

The role played by rating agencies in the debt arena is indispensable. It is through their verdict that investors are guided to invest or divest in certain financial products. Here, we do not only refer to private investors but also to institutional investors. For instance, insurance companies are required to hold the majority or the totality of their bond portfolio in "investment grade" securities, which means rated BBB or better. The reason behind this requirement is the limitation of credit risk. Consequently, investors habitually start by sorting investment by their assigned ratings, the latter being provided by rating agencies.

Nevertheless, there is key information about rating agencies that rating users typically ignore. On top of the list, potential conflict of interest resides. Unbeknownst to most debt industry outsiders, firms such as Standard & Poors, Moody's, and Fitch, -which are generally seen as bastions of rigorously objective analytical prowess- are usually paid by those being evaluated.

Furthermore, there is questioning over their recent incompetence. Issuers nowadays require their rating agencies to get into areas that are beyond their skill, specifically, into "structured products". It goes without saying that these are rather complex, and are often created by recombining and trenching other bonds, and sometimes by leveraging them through the use of derivatives. The problem is that these new structured products are not only complicated but are all so-often volatile and highly risky. Thus, a ratings miscalculation is more likely to damage clients' portfolios.

A factor aggravating the trouble is the lack of competent analysts: agencies have low pay scales relative to Wall Street, consequently, outperforming analysts that easily understand these new

products are generally recruited by investment banks which offer them better compensation schemes.

Another issue the industry has is that no matter how incompetent rating agencies seem, it still need them, as much for investment banks' new structures as for clients willingness to invest. So it faces the obligation to be provided with their services without being sure that they will know how to.

Additionally, the fact remains that there is no market discipline on these firms. One would think that, in such a case, competitiveness would drive their analyses to higher standards. However, that same one would be forgetting that new entrants are generally discouraged by the harsh task of developing a competitive level of expertise and building relationships to have in return a potentially nice but limited profit level.

Rating agencies problem

The meltdown in mortgages for "subprime" borrowers is claiming its latest casualties: credit-ratings companies. The latest trades of many bonds backed by these subprime mortgages revealed a widening gap between investors' perception of their risk and the opinions of large ratings providers like Moody's Investors Service, Standard & Poor's and Fitch Ratings. Whereas the latter assigned investment-grade ratings to some subprime-mortgage ended up trading at prices that imply they could be as risky as junk bonds. Yet most of their ratings remained unchanged over a long period. As a result, a misconception of risk stayed present, investors' losses accumulated and blame ended up on the ratings.

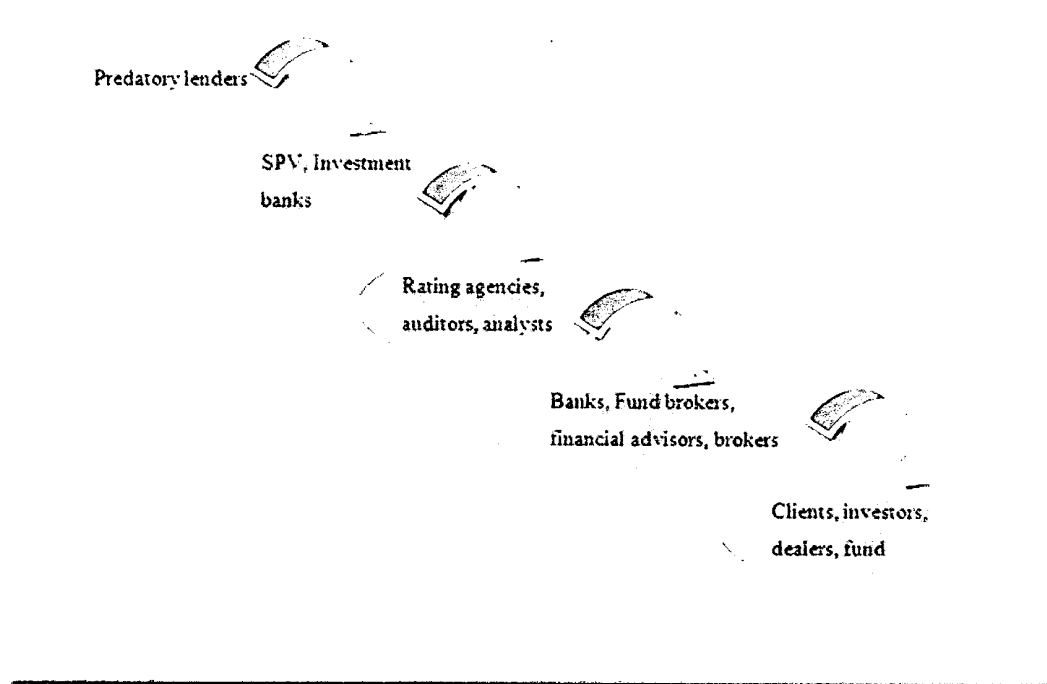


Figure 2: Structure Products Involvement Chain

Lack of skill

As today's "structured finance" market become increasingly fast-growing and complex, inquiries about whether the big three – Standard & Poor's, Moody's Investors Service and Fitch Ratings – are up to the job had started to shouted out loud. Nowadays, mortgages, car loans, corporate bonds and many other types of debt are packaged and repackaged by investment banks and sold on to different types of investors, ranging from pension funds and insurance groups to hedge funds and bank trading desks. The key to a successful deal is securing the right credit rating.

Trouble is that credit rating agencies are rarely at the forefront in acknowledging a sudden change in a company's financial fortunes or a rapid deterioration in the overall credit environment.

Besides, they seem to have had a "model failure". Explanation follows: To come up with ratings on mortgage bonds, ratings companies use financial models that consider historical default and

loss rates among pools of mortgage loans. They try to predict how newer loan pools will hold up under various economic scenarios. Forecasts and assumptions about interest rates and movements in home prices are factored in. The models help determine how many bonds backed by a pool of loans may be so insulated from losses that they can be rated AAA -which connotes as little risk as a U.S. Treasury bond- and how many are less protected and thus bear weaker ratings like A or BBB.

In the mortgage cases, bonds are backed by loans whose value exceeds the bonds' principal so as to provide a cushion for expected losses among the mortgage pool. As the subprime crisis ignited, many of the ratings started to be called into question as market prices of some subprime bonds suggested investors expected them to lose some of their principal.

In March 2007, Brian Carlin, head of fixed-income trading at J.P. Morgan Private Bank acknowledged the underlying problem: "What's driving the market now is that defaults are coming significantly faster than historical simulations". However, as concern over the image of the rating agencies sector grew, some figures preferred to remain silent, since if ratings companies had to downgrade, rapidly, a large number of subprime bonds issued in 2006, it would have signaled that they failed completing at rating new issues, i.e. that they completely misjudged the risk.

Still, some other agencies, Moody's and S&P, for example, have had to downgrade dozens of newly-issued securities backed by US subprime home loans as late mortgage payments and defaults by borrowers were spiking more severely than the agencies initially expected. Also, Moody's was forced into an embarrassing U-turn in March when a new method of rating banks was adopted; the latter took into account the likelihood of government bail-outs.

Finally, with new deals/structures piling up every day, rating agencies have been put under a tremendous pressure to cope with changes, first, by facing the constraint of learning new ways to rate, and second, by struggling to retain talents. As Richard Stein, head of the capital markets practice at recruitment firm Korn Ferry, says, structured finance rating experts are very valuable to investment banks. "It's not unusual for banks to offer analysts compensation packages that are three or four times what they're earning at the rating agency". Therefore, it is no wonder that many analysts expressed clearly that rating agencies have not been competent enough to assess

the combination of products' market risk and leverage lately.

Conflict of interest

For years now, the ratings companies having been making profits by charging issuers for rating bonds, those being backed by home loans to borrowers with weak credit, known as subprime mortgages. As analysts say, the ratings providers "were at least as interested as the investment banks in getting the deals done because they would get paid for rating them"

As figures have shown, Moody's made 44 per cent of its 2006 revenue from structured finance deals. Such assessments also command more than double the fee rates of simpler corporate ratings, helping keep Moody's operating margins above 50 per cent. It is only normal that the agencies' "issuer pays" model represents a serious potential for conflicts of interest. The scale of their dependence on investment banks for structured finance business gives them a significant incentive to look kindly on the products they are rating. There are therefore questions over their role and objectivity.

The possibility for conflicts of interest is quite similar to those that emerged in the audit profession when it drifted into consulting. Here, the integrity of the auditing work was threatened by the demands of winning and retaining clients in the more lucrative consultancy business, a conflict that ultimately helped bring down accountants Arthur Andersen in the wake of Enron's collapse.

As a result of the stated above, rating agencies have become part of the pool of guilty parties in the subprime mortgage crisis.

Guilty parties

Among the ones held responsible for the late mortgage meltdown, the lenders who originated subprime loans stand. These sought ways to shift these assets off their balance sheets. Special Purpose Vehicles, via securitization and Investment banks, created Mortgage Backed Securities (MBS) and Collateralized Debt Obligations (CDO) out of the pools of subprime loans. To be able to sell them to institutional investors, the SPVs and investment banks had to acquire the indispensable element for the success of these instruments: the willingness of the rating agencies

to grant investment grade ratings to the instruments, since the likeliest buyers for these kinds of assets, pension funds and insurance companies, are usually required to invest in investment grade securities. The second party to blame is thus the rating agencies. These became very involved in the deal making process. Some investors affirm that if deals were not made under the “issuers paid” model, the rating agencies would have been more objective, and as a result, a bit more severe. But, the business of rating CDOs and other mortgage backed securities became a very important part of the rating agencies’ business. For example, according to *Fortune* magazine, Moody’s net income “went from \$159 million in 2000 to \$705 million in 2006, in part because of increases in fees from ‘structured finance’ and that was mainly thanks to their involvement in the deal making process.

As rating agencies’ role was not passive and not limited simply to expressing an opinion on creditworthiness, their role became “iterative and interactive,” and consisted of informing issuers of the “requirements to attain the desired ratings in different tranches and largely defining the requirements of the structure to achieve target ratings.” In other words, the rating agency helped the issuers to structure the deal so that the agencies could give the deal an investment grade rating which, once obtained, entitled the issuer to sell the instruments to institutional investors. That level of implication resulted in making them guilty parties.

The “Chateau de cartes” effect

Guilty parties, yes! Why? Because the industry entered a financial vicious circle due to their grant of ability to sell subprime loans. As investment grade assets’ sales fueled enormous growth in the subprime loan industry, greater access to credit for potential homebuyers was created. In turn, home prices rose, which allowed the mortgage pools to show a very low default rate. The latter reinforced the apparent validity of the alchemy that transformed subprime loans into investment grade securities.

The problem arose when the recent downturn in the residential real estate market appeared. The deterioration of the subprime mortgages threatened this arrangement. When rating agencies started to downgrade the investment- grade securities, a cascading effect followed: existing investors began to divest, potential investors stopped considering the option of investing in such

securities, which in turn made it worse because a major source of liquidity concretely evaporated.

The Defense of credit rating agencies

Seeing that the finger-pointing was heading their way, executives at ratings companies started first by denying that a conflict existed. "Issuers pay us because investors believe our opinions about the risk of the assets have value," says Glenn Costello, a managing director at Fitch. Relatively to this argument, it is worth recalling the Orange County bond default. Back then, rating agencies were sued for conflict of interest. However, they successfully argued that their rating activities were protected by the First Amendment, as mere opinions of creditworthiness. Although they got out of trouble in that case, it is important to remember that their indispensable role in the creation of these mortgage backed securities, including in particular their "interactive" involvement in the structuring of the deals, made them participants in the transaction. This, according to legal advisors, suggests that there "does seem to be some basis to consider" that the rating agencies may have liability as "underwriters" under Section 11 of the Securities Act.

Another fact is that the rating agencies themselves emphasize that preserving the credibility of their ratings is crucial to their success. In structured finance, as elsewhere, they say they manage their businesses carefully to avoid conflicts and to maintain objectivity. For instance, Gloria Aviotti, head of global structured finance at Fitch Ratings, points to evidence that structured finance ratings are statistically comparable with, and at least as stable as, corporate ratings. She also says rating methods for structured products – those including MBS and/or CDOs – are among the agency's most clearly and publicly defined. That transparency, she argues, helps avoid conflicts because it gives investors the opportunity to see that Fitch treats all similar structures in the same way.

Noel Kirnon, a senior managing director at Moody's, adds that "investors have the ability to challenge our work constantly". He says there are plenty of tools available to help investors evaluate independently the securities they are offered.

The problem is that structured instruments are to be analyzed *and* sold with great care, no matter how transparent the rating agencies are. The reason behind this statement is that structured instruments are potentially more vulnerable than traditional corporate debt, due o the simple fact

that in the event of a downgrade, investors tend to rush into selling. It is therefore of utmost importance to acknowledge the fact that the prices of the two types of instrument (traditional corporate debt and structured financial products) behave in different ways, even with the same rating.

Also, rating agencies defend themselves by highlighting that their ratings explicitly do not address market pricing or trading liquidity for the security in question, but rather focus on the likelihood of default. However, some investors may not appreciate that distinction and could be surprised by volatile prices. They even note that many newer structured instruments have not been through a serious, broad-based market downturn, and that, as a result, predicting their behavior is harder than other instruments'.

For Ian Bell, head of European structured finance at S&P, banks generally come to them with a proposed transaction and they explain how it might be rated under their criteria. In many cases, the transaction is then restructured by the bank in order to meet their criteria. "There's nothing sinister about this process – we don't advise on how deals should be structured or arbitrate on which deals can proceed or not."

Regardless what agencies may use as defense, the facts remain that ratings can by themselves create or render obsolete particular kinds of securities, and that a single downgrade could tip countries towards recession or companies towards bankruptcy. It is thus important to recognize their crucial role and responsibilities, and to make sure they do apply their code of ethics, as this is till now, the only chance for them to recoup their image of integrity.

Rating agencies legal troubles

Although we can find in Moody's code of conduct that "Moody's has no obligation to perform, and does not perform, due diligence", and that agencies are on fairly strong ground that their ratings are just opinions, these facts do not absolve them from liability risk. As Fran Laserson, vice president of corporate communications at Moody's, puts it "We perform a very significant but extremely limited role in the credit markets. We issue reasoned, forward-looking opinions about credit risk", rating agencies forget the fact that they are used as benchmarks by institutional investors, and that they are central drivers particularly in the riskier areas of asset-backed securities markets. For instance, the pool of buyers would be much smaller without a

rating because pension and mutual funds hold only investment-grade bonds. CDOs are too complex for even sophisticated investors to analyze, so the ratings take on great importance. "It is unreasonable to think that people could do the quantum math to figure out the ultimate aggregate default rate on a CDO". Consequently, there is a greater expectation that the gatekeepers will scrutinize the underlying credit.

In July 2007, the attorney-general for the state of Ohio, Marc Dann, has accused the financial ratings agencies of fuelling America's mortgage crisis by turning a blind eye to the risks attached to bonds backed by "sub-prime" home loans. Previously, Wall Street firms had taken on many of the riskiest home loans from the mortgage banks and had packaged them into bonds. The latter were given a risk rating by rating agencies, among which we find Fitch, Standard & Poor's and Moody's, and were then sold to pension funds and other institutions. Dann accused that "The ratings agencies helped to keep the market on fire by ensuring that these bond offerings got high enough ratings for them to sell, providing new funds for the mortgage originators to make new loans to increasingly unsuitable borrowers" and that "They aided and abetted the process by blessing these issues, even though they knew, or should have known, that many of these bonds were backed by mortgages that had been fraudulently made."

It is later on that they started to warn that defaults on some home mortgages were rising unexpectedly. The announcement resulted in the bond market stumbling; owners of mortgage-backed securities started to expect a lower return on their investment, and in some cases even a loss. Soon, the impact of the announcement on the bond market spread to the stock market, which on August 3rd, 2007 suffered its worst day since 9/11.

Finger-pointing on rating agencies included the fact that their ratings gave investors a false sense of security about the credit-worthiness of the mortgage bonds. Residential mortgage-backed securities issued against the collateral of hundreds of home mortgages, via the use of complex financial models based on extensive data, were forecasted to have of a low probability of bonds' default, especially thanks to the fact that some higher quality mortgages were included in the collateral to compensate for the riskier assets. The trouble then appeared to be at the level of the performance of borrowers with weak credit histories, i.e. subprime borrowers.

Considering the legal side of the affair, rating agencies are potential guilty parties due to the facts that they were involved in putting these issues together; they were not merely inspectors, but rather architects of the disease. However, if we take the defendants' side, a permanently updated list of arguments is there. Of utmost usefulness is the institutional investors' appetite for high-yield bonds.

Whereas low interest rates are great for borrowers, for fixed-income investors, they mean low returns. Investors kept on trying ways to improve yield, and ended up accepting too much risk. Furthermore, it is now in the nature of business in capital markets to make profit in good times - when default rate is low-, and to face losses when credit crunch hits the market.

Also, a blame put on investors is their abusive practices to use too much leverage to acquire portfolio of mortgages.

Another excuse rating agencies use is that, usually, they assess the likelihood that mortgages will be repaid, and that changes in market's valuations of the mortgage portfolios are not directly connected to default rates.

Still, no matter what are the excuses used by rating agencies, securities regulators, the Securities and Exchange Commission are investigating whether credit-rating agencies such as Moody's Corp. and Standard & Poor's Corp. followed proper procedures for rating mortgage-backed securities. As it has been found, some specific ratings were wrong, and the subsequent downgrading actions by the same ratings agencies have had a serious impact on the financial system. The question remains whether rating companies were improperly influenced by issuers and underwriters of such securities to publish high ratings. The examination is also looking into whether the agencies followed their stated procedures for managing conflicts of interest. One of the defendants, for instance Vickie Tillman- executive vice president of S&P Credit Market Services- argued that this questioning ignored the benefits of the "issuer pays" model, stating that in the absence of the latter, public ratings would become subscription-based, and would accordingly stop being free of charge to investors.

In January 2008, credit rating agencies defended their role in the credit squeeze that began in August, saying some investors expected too much from their ratings, that they misused the latter, stating that they did not acknowledge that rating agencies only covered credit risk. Nevertheless,

they ended up being criticized by France, Germany and the European Commission for being too slow to warn investors of the risks of buying U.S. subprime-related products.

In conclusion, it is highly probable that agencies did provide the investors with all the necessary information to evaluate the securities, but that those did not pay enough attention. It is therefore of utmost importance to underline the critical role one has in assessing, analyzing and choosing investments.

Whether or not litigation against the rating agencies ultimately emerges or is successful, the larger threat of the collapse of the market for mortgage backed securities is a reality. Between 2003 and 2006, nearly a trillion dollars of CDOs were issued (\$500 billion in 2006 alone). The deterioration of these assets caused substantial investment losses for investors and the availability of credit have been seriously affected. Some worry about the potential for conflicts of interest, given that investment banks rather than investors pay for ratings. Others simply think the agencies can be confused by the complexity of the deals they are asked to rate, and are not equipped to keep up with the creativity and resources of the banking world.

Relatively to our topic, and regardless who end up being guilty, with structured finance deals created nowadays- while using derivative instruments as well as bonds and loans-, some investors are just being incapable to keep up with the complexity and are, as a result, relying on the rating agencies' opinions more heavily than ever before. The majority in our case, due to their lack of knowledge, rely solely on their Financial Advisors. Accordingly, it is extremely important to acknowledge the latter's duties to research the specifications of the product, to compare the different ratings and to inquire about explicit *and* implicit deals that would involve the product' issuers, the rating agencies, the dealers and the brokers.

3.4 Post-structure phase

3.4.1 Promotion and sales of structure products

Financial Advisors make their budget by advising their clients to make transactions. At the end of the year (or sometimes quarter or semi-annually) the total commissions paid by the advisees to the bank are calculated. Hence the bank counts the profitability from each client.

Each financial advisor has a share in the department's profits. The biggest the share is, the biggest is the bonus earned. The reward becoming the ultimate drive, financial advisors, traders and dealers increase the transaction numbers of their relative clients.

Unfortunately, this comes often at the expense of the clients. Conflicts of interest result, as advisors have more interest in deals than in the wealth of the clients. Worse, they tend to communicate poorly the investments information.

Promotion and sales of structured products

As it has been earlier mentioned, structured products are often complex. For an average investor, understanding its specifications is rather complicated. Consequently, he ends up relying on his advisor whenever he is about to consider a purchase or a sale. The problem is that advisors tend to unfairly comfort their clients by telling them they will do the assessment for them. Whereas some do effectively, most just rely on the analysis of the sale proceeds. There are some who do analyze the product at the preliminary phase, but who do forget to do so afterwards. The latter fact is problematic, since as market fluctuates, rapid decision making is always needed.

Promotion of structured products is only adequate in cases when the product fits the investor profile. Furthermore, whenever such investments are promoted, the least a Financial Advisor could do is explain fully its nature and function to the buyer. His duty does not stop here; in the contrary, he should keep an eye on the advised products at all times. Till the sale timing comes, the advisor should keep on informing the client about his belongings' performance. When it is time to sell, it is the client's right to know if the transaction is in his interest.

Ethics intervene in the full process of advising, since they require relationship managers to hold responsibility for the acts of their clients. Regrettably, as legal blame is often hard to put on advisors, relationship management often allow clients' wrongful assessment of risk, and frequent advisors' misjudgment of their clients' wants and needs.

3.4.2 Redefining communication in Financial Advisory

A financial advisor is one who is entrusted with the wealth of the advisee. The latter relies heavily upon him to get adequate advices concerning potential existing investments in his portfolio.

Of utmost importance, and in order to avoid misunderstandings, the advisor should be able to send the right advice message. Therefore, he needs to be competent and savvy. His duties also include making sure the advisee receives correctly the message. He should consequently check/maintain adequate communication channels. To complete the characteristics' list of a performing advisor, listening to clients' needs and wants is primordial. Understanding those is, of course, also, a must.

3.4.3 Introducing Investor Profile identification procedures

A good start to identifying advisees' needs and wants is achieved by studying the latter's investor profile. But before we do, let us first remember key communication issues.

Communication problems are known to be due to;

- Conflicting or inappropriate assumptions
- Different interpretations of the meanings of words (semantics)
- Differences in perception
- Emotions either preceding or during communication
- Poor listening habits
- Inadequate communication skills, i.e. insufficient feedback, differences in interpretations of non-verbal communication

In the financial advisory services, conflicting or inappropriate assumptions often result due to the absence of detailed explanation of investment risks and rewards. Most of the time, advisors and clients fall in the trap of thinking they are understood, whereas they are not. While one or both assume that communication is flowing as intended, one tends to move with the dialogue without allowing feedback to indicate whether clarity of expression and communication has been achieved.

As we will present in the following chapter, in the Levant area, misunderstandings due to semantics reveal to be at alarming levels, leading to amazing *quiproquos*. For instance, Levant investors, when asked about their risk aversion or appetite; tended to answer as if they were

extreme risk takers, whereas, in fact, the study revealed they were very conservative. This is caused by the fact that some financial terms and expressions invite multiple interpretations. Another key reason is that perception of investment attitude relatively to risk, and of economical events differs from an age to another. For instance, whereas the word “conservative” appeals to wisdom for mature investors, it connotes with “loss of opportunity” for younger ones.

Another example is the case where we had two clients with quite similar portfolios. They were both exposed to subprime securities; however one was shocked while being updated on the subprime crisis events, whereas the other was almost indifferent. As we looked further into behavioral interpretations, we found that the source was simply selective perception. Each had a different way of screening out information. The message (news) was plainly distorted, the first wrongfully interpreted the message and started to look for someone to blame, whereas the other listened to only a part of the message, and hence decided to buy more of these securities.

Emotions do also affect the way messages are sent or received. Communication during periods of high emotion usually fails. Listening is very important. It is evident that a relationship manager should not just hear or collect information from his clients. He should actively listen, and be able to analyze and interpret the data. His attitude towards the client counts too. He should respect the latter and expect to profit from the communication. In other words, he should listen actively *and* effectively. Sales people often tend to get impatient with listening and prefer active involvement by talking, before the client finishes speaking.

Conclusion

Culture, education, verbal skills, and training can all affect the way a person communicates. The ability to feel confident in conversations, in presentations, or in speaking to a group, are all skills that a financial advisor should have. He should definitely be a good talker, but he must also be a good listener.

Chapter 4 Levant Investors' Profiles

In the current challenging economic environment, to be able to survive, banks, like other financial and non-financial institutions tend to run their businesses as efficiently as possible while doing all that is possible to increase sales. Unfortunately, this exclusive focus on sales significantly undermines the potential benefits and overall value that could be gained if more attention was paid to the real needs and wants of clients.

4.1 Defining clients' needs and wants

Investment strategies are very personal. The right investment plan must fit the client's own personal financial needs, goals, and challenges as well as fit his personal convictions that are unique to himself. A client could belong to the risky investment type of investors, as he could be a very conservative investor. It all depends on his risk tolerance. There are also other variables like the frequency of trade that need to be taken into consideration. Although some clients have variable patterns, most do abide by regular timing intervals. A client could have specific wants concerning the composition of his portfolio. He could even have his own strategy, and could be able to make his own researches, analyses and deductions.

There are several factors to take into consideration when designing a client's investment strategy. As we will see below, all are particularities, and each should be paid specific attention.

4.1.1 Questionnaire structure

In February 2008, a questionnaire has been designed to enhance the financial advisors' knowledge of their clients' expectations. It was distributed to several investors at BEMO. Then, it has been used to develop asset allocation strategies that were to fit clients' investor profiles. Its benefits were remarkable as investors felt more confidence in their respective relationship managers' advices. Indeed, thanks to the mutual collaboration of the financial advisory team and the investors' pool, a new understanding of the asset allocation importance was achieved.

Several key financial investment theories had to be explained, but the one that showed the greatest client satisfaction was the clarification on investment risks. The latter enabled our

advisees to finally acknowledge the investor type to which they belonged, and hence, the investment options that suited them best. It also enabled us to realize how various were their levels of investment' know how. Whereas some did know much about savings and investment products, some others had only some understanding of the main investment products. Only a few had a solid grasp of return potential and understood the risk levels of different types of investment.

Another key variable we focused on was the clients' age. Whereas we used to neglect this factor, we finally underlined its crucial role. In reality, this is by far one of the most important aspects of asset allocation. For several investors, portfolio maintenance had very specific goals. Those included the enhancement of retirement accumulation, the collection of an amount to be left as heritage, the management of an entire lifetime savings, the funding of an insurance contract, of education, or simply wealth accumulation. Categorization of these goals showed that age was the main factor behind the needed repartition.

In order to better assess the clients' investor's profiles, the questionnaire has been divided in three main categories:

- Time Horizon and liquidity needs
- Investment Objectives and diversification wants
- Risk tolerance and investor typology

Time Horizon

To be able to plan for adequate asset allocation, financial standing and liquidity needs must be assessed. A financial advisor must know when his clients will begin withdrawing money from their account. If the time span is wide enough, he could compose a portfolio that carries a greater potential for appreciation and higher level of risk as there would be more time to weather the inevitable ups and downs of the market.

Other needed information is the amount of cash reserves the client may want to set aside for emergencies. As an advisor, the relationship manager should remind his advisee to take into account his eventual liquidity needs. Also, as he may be assumed to be the responsible wealth

manager, he should secure the client's awareness of inflation effect. He may need to inform him about it, as it affects his purchasing power. He should also know if his client will need to curb his spending or put a project aside in cases where his investments fell over a specific period.

Finally, of matter to liquidity needs assessment, a financial advisor should take into account the client's age factor. For instance, young investors are less likely to need their money any time soon. Consequently, the advisor could encourage him to invest more aggressively in stocks -for example-since these, generally, have the best long term results, whereas, if they were older, he could advise them to move into securities with fewer fluctuations such as cash securities or bonds. The ultimate output he should reach is the ability to determine his client's expected financial goal within a specific timeframe.

Investment objectives

After determining the timeframe within which he will have to perform on behalf of his clients, the financial advisor should start looking forward to learn more about the latter investment objectives. To be able to do so, he will first need to acknowledge the boundaries within which he will operate. For instance, it is relevant to know if the client will need to make a large withdrawal from this portfolio, and if so, when? He should also know how large the withdrawal will be, how much he plans to spend from his portfolio periodically, and if it applies, how much he plans to contribute to this portfolio each year.

Investment objectives are mainly about the client's primary concerns. If he only plans to maximize the returns on his investments, he may be willing to accept large fluctuations in the value of his investments and probably substantial risks of loss. In the mentioned case, the financial advisor should ensure the client is certain about the proportion of his total investable assets he would like to use, and is aware about the appropriate loss that he would be willing to accept. He should then figure out what is his advisee' expected annual target rate of return.

Goals and objectives must then be defined more specifically. As mentioned earlier, these could be to increase or create capital; improve capital growth of investments; diversify existing investments; provide for children's education fees; provide for a comfortable retirement or provide funds for their children's future. As these are just the most common goals, there is a wide

pool of objectives. Identifying them is a key issue, as these shape the asset allocation and provide guidelines for the subsequent portfolio management.

As the review of our clients' investor profiles took place, we chose to classify their investment objectives in the following classes:

-Income: Preservation of capital with major emphasis on generating current investment income. In this case, most investment income will be withdrawn and spent. For instance, the client may want the portfolio to produce income to live off of while minimizing risks of principal loss

-Income and Growth: A combination of current income, preservation of capital, and capital appreciation, with the primary consideration being preservation of capital and current income. Here, some income will be withdrawn. This would be the case of a client that wants the portfolio to produce income, but also provide enough principal growth so the income will keep pace- or outpace- inflation over a long-time horizon.

-Growth and Income: A combination of capital appreciation and current income with the primary consideration being growth of capital. Most income will be reinvested. Here, the investor wants his portfolio to grow moderately to accumulate wealth for future goals.

-Growth: Maximum capital appreciation (long term growth), accepting higher risk and volatility, with little or no income expected or withdrawn. This would infer the client wants the portfolio to grow substantially to accumulate wealth for future goals.

By categorizing clients in the above classes, the financial advisor can better project his tasks. Where the investment goal is capital preservation, he will need to plan transactions in a way to protect the value of his client's investment. Where the client looks for capital growth, his main concern will be to find ways to increase the value of the advisee original investment. As for the "Growth and Income" category, the advisor will have to plan for income to meet his client's current needs. Lastly, pure growth is an objective that will allow the advisor to plan income for his client's future needs and to allocate his funds into riskier assets.

Finally, the advisor needs to ensure he grasped diversification wants of his clients, after informing them about this technique benefits (lowering concentration risk). He should also, for example, find out if there were any legal, social, tax or specific constraints that may be relevant

to the management of their investment portfolio; or if there were any limitations to holding specific asset classes in this portfolio (e.g. no international investments, no emerging markets, no hedge funds).

Risk tolerance

Although this is the last category of the questionnaire, it is nevertheless the most important one. A bad, wrongful assessment of a client's risk tolerance has shown to be the most problematic issue in financial advisory, at least at BEMO.

It is very important to know how an investor feels when the value of his portfolio investments fluctuates. While interviewing various Levant investors with different backgrounds, we have found that they had a typical habit of blaming their financial advisors when they were negatively surprised by their portfolio performance. Through the collected data analysis, we reached a conclusion that the source of this kind of misunderstanding was, most of the time, clients' risk tolerance. When the latter was verbally inquired about, it used to look moderate to aggressive. However, when deeper analyses were conducted, it often showed to be very conservative.

Some investments fluctuate more dramatically in value than others but may have the potential of a higher return. It is important to make sure that, at their selection phase, they fit the client's level of risk tolerance, and that he knows that greater volatility often involves bigger risks of loss. For that to be achieved, one should look at what influences most the investor. The drives could be the potential gain, the potential loss or a combination of both.

Inhere also, the concern of the client reveals a lot. The assessor should identify whether he is most concerned with protecting his principal value of his investments or if he is rather willing to place the majority of his investments in relatively high-risk assets.

A tool to better fine-tune asset allocation, relatively to risk tolerance, is used by learning how the client would react to a average loss. Whereas some would immediately sell all of their losing investments, some would hold, and some other would even buy more of them. Even at that stage, further inquiry about the reason behind his decision is needed, since many times, investment decisions were backed by wrongful assumptions, analyses or expectations.

4.1.2 Research objectives

Although the three categories have been taken into account, the objective of this questionnaire was mainly to identify our clients' risk tolerance. In light of the recent market changes, such a re-assessment was urgently needed.

We categorized clients in three main classes, and made room for intermediary classes:

- Conservative
- Moderate
- Aggressive

The clientele' pool that has been interviewed verbally and in writing (via the distribution of questionnaires) has had a population of 100 clients. The results were as follows.

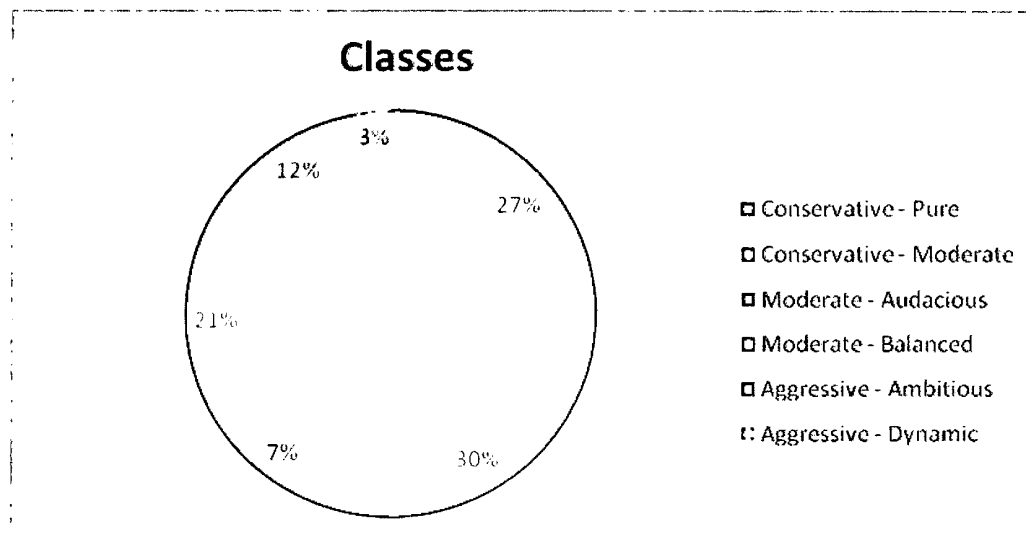


Figure 3: Clients distribution by investor profile.

Conservative

57% of the investors appeared to be from the *conservative* type. While analyzing the questionnaires and interviews data, we concluded they were attempting to achieve maximum

current income with 'a preservation of capital and liquidity. Their primary objective was to look for safe financial products. Their risk tolerance was low, and they were most comfortable investing in products where the interest rate, maturity dates, and payout schedule of interest earnings were predetermined. Typical purchasers in this class are risk averse. They look for stability of principal and seek a market rate of income in very short term securities.

Of the above stated category, an intermediary class of *moderately conservative* investors was created.

Moderately Conservative

53% of *conservative* investors were classified as *moderately conservative investors*. They aimed at achieving long-term growth of principal plus current income. Thus, they allocated assets to government-backed securities, corporate bonds and some conservative stocks.

Typical purchasers in this class are willing to assume a low-to-medium level of principal risk and seek relatively steady current income with conservative growth potential over time. As for the other 47%, they were assessed as purely conservative, as they did not invest in stock or any other volatile investment.

Moderate

The number of *moderate investors* was amounted to 28%. Their main goal was to achieve long-term growth of principal and income by allocating assets primarily to stocks. The latter were rather believed to offer growth potential and above market dividend income. In this class, investors seemed to be seeking capital growth and income over time, and usually had a minimum time horizon of 5 years. Moderate clients are willing to accept some share price volatility, but security remains their ultimate goal. Most, therefore, invest the majority of their funds in classic financial products carrying a certain level of risk.

Audacious

The *Audacious investors'* class is a sub-category of the *moderate investors'* type. Out of 28 clients, 25% have showed to be ready to tolerate a little more risk to achieve long-term capital growth. While remaining cautious in their strategy, they invested close to half of their portfolio

in the stock market. Their investor profile is very close to the *Aggressive* type of investors, however these tend to invest in value stocks rather than in growth ones.

Aggressive

As figures show, these are the minority in the Levant area. Although the ones who belong to this category tend to invest colossal amounts, they remain a small portion of the entirety. These go to achieve maximum long-term capital growth by allocating assets primarily to stocks of small companies or narrow market segments. Typical purchasers in this class have a financial horizon of 5-10 years or longer, and are comfortable with potentially sharp volatility in share prices and have little or no concern for current income. The aggressive purchaser should expect to have greater risk exposure and reward potential than the one who directs assets to primarily larger capitalization companies.

This category has been sub-divided into two quite different categories, as investors from one to the other have reasonably different attitudes to risk.

Ambitious.

12 clients of the interrogated pool have been classified as *ambitious*. The reason behind this differentiation is that those usually look for high-growth potential over the long term. Since they aim for higher returns, they accept a higher level of risk for up to two-thirds of their portfolio. The latter is frequently invested in the stock market.

Dynamic

The *Dynamic investors* have a high tolerance for risk and are looking for high-growth investments. They usually opt for the potential for capital appreciation in the stock market, and consequently, their portfolios are almost entirely made up of stock securities. These are habitually high risk takers. In the analyzed pool, they were only 3%.

4.1.3 Investors' profile and know how

The investors from which we pooled profiles belong to the Levant geographical area, mainly Lebanon and Syria. Some exceptions had Gulf countries nationalities. Although they come from

different backgrounds, the analysis result has been quite concentrated: most have “conservative” investor profiles.

The interesting discovery is that these used to have portfolios that fitted aggressive investors’ profiles. The reason behind this discrepancy was mainly their lack of Investment know how.

Case Processing Summary

	Cases					
	Valid		Missing		Total	
	N	Percent	N	Percent	N	Percent
Clients' Risk Awareness	100	100.0%	0	.0%	100	100.0%

.Descriptives

		Statistic	Std. Error
Clients' Risk Awareness	Mean	4.29	.198
	95% Confidence Interval for Mean	3.90	
	Lower Bound		
	Upper Bound	4.68	
	5% Trimmed Mean	4.16	
	Median	4.00	
	Varjance	3.905	
	Std. Deviation	1.976	
	Minimum	2	
	Maximum	9	
	Range	7	
	Interquartile Range	2	
	Skewness	.828	.241
	Kurtosis	-.191	.478

Figure 4: Clients' Risk Awareness
Source: SPSS

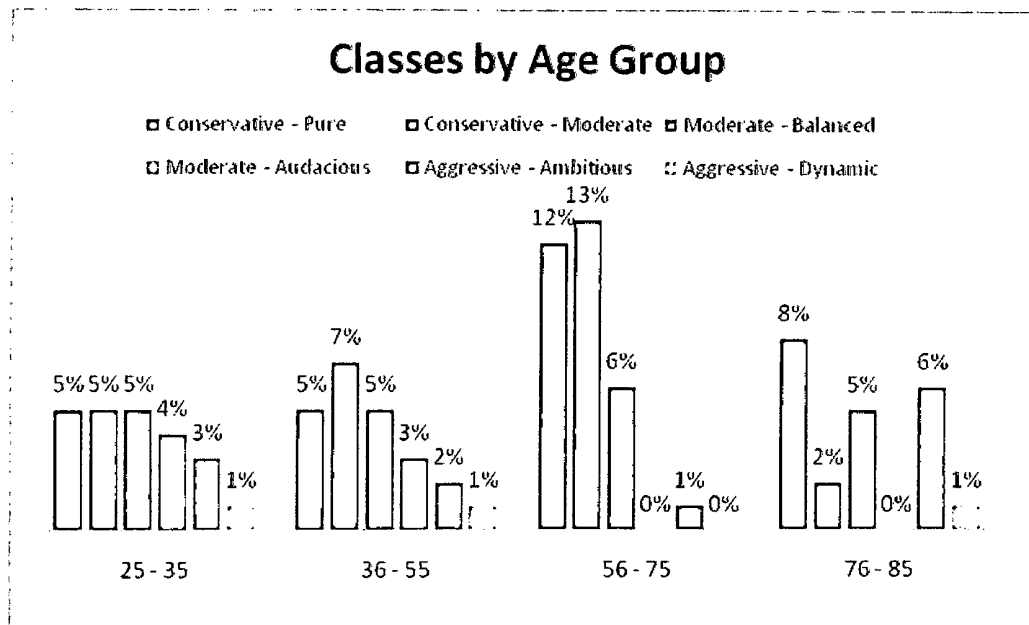


Figure 5: Classes by Age Group

Investment Products

Some clients, who turned out to be conservative investors, had portfolios comprising mainly stocks. When asked about the misfortunes they faced during their investment experience, they all used to complain about their financial advisor performance. Listening further to their remarks, we acknowledged the fact that they were totally unaware that stocks were classified as highly volatile and hence risky products. For them, they thought these were all safe, but that some performed worse than others. Hence, they used to blame their advisors for the wrong picks.

Some others were unaware of other financial instruments. They simply used to think that the only financial markets' investments they could invest in were stocks. As one stated, he thought that investing in the same securities as one of his acquaintances -the latter having been lucky in the "boursa"- would allow him to achieve the same gains.

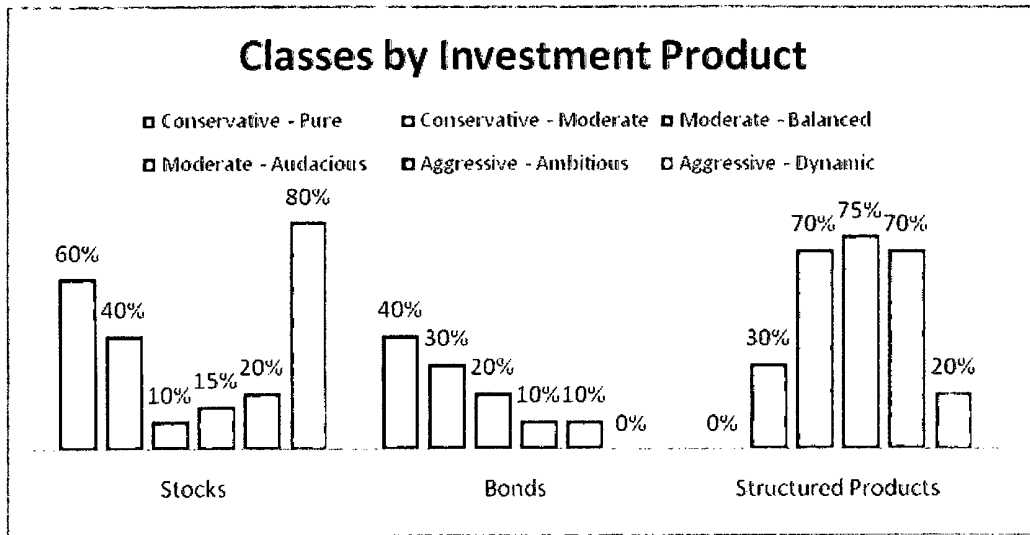


Figure 6: Classes by Investment Product

There are many other examples of alarming investor statements. However, the conclusion we reached was that there was an urgent need to explain more extensively to clients what the specifications of each financial product were. We also established a system where each client would have sign on an “investment specifications” format, every time he decided to buy from a new category of structured products.

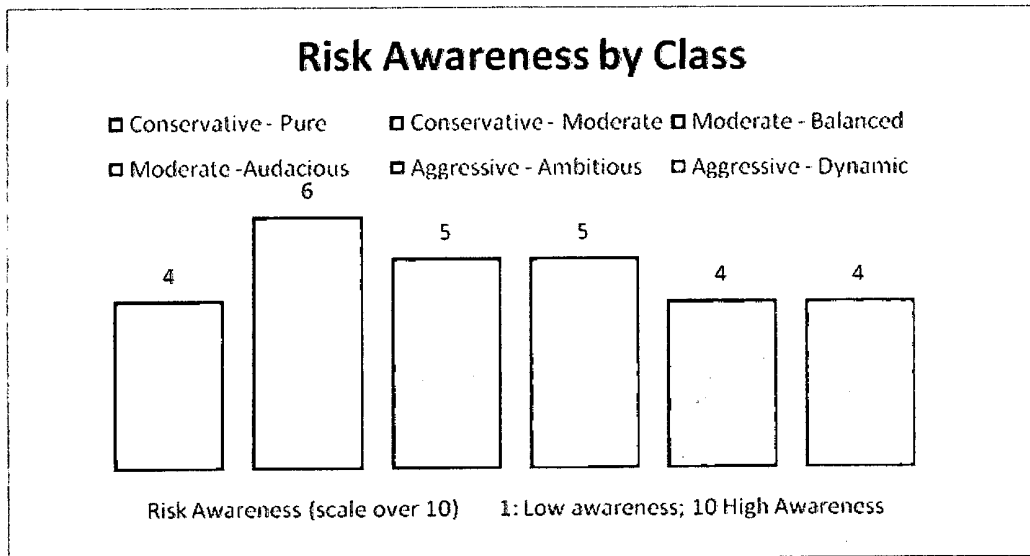


Figure 7: Risk Awareness by Class

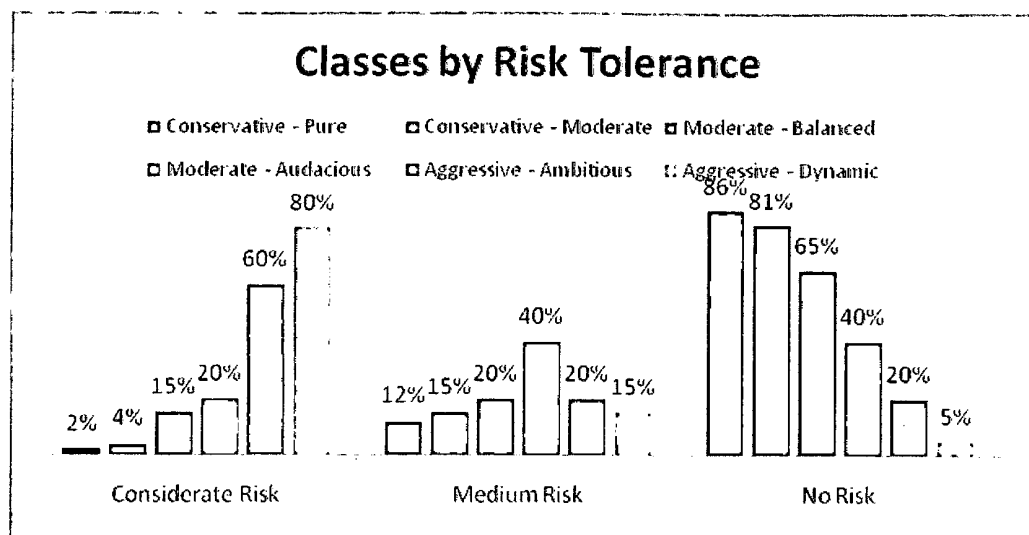


Figure 8: Classes by Risk Tolerance

Investment Techniques

Whereas some clients were not familiar with the different securities specifications, some others were quite savvy. The problem was that they used wrong investment techniques. The reason lied in the fact that they misconceived several trading techniques.

For instance, there are some who thought diversification was only about buying several stocks, some other thought it was about buying stocks with different nationalities, etc. Inhere also; we concluded that we needed to explain more about how they could hedge their risks, and to widen the palette of investment products we used to promote.

An interesting deduction we reached was that clients were more at ease in trading when they were provided with more technical information about securities, even when they were not intending to hold them in their portfolios.

4.2 BEMO Private banking

BEMO's client culture is mainly the one of typical Arab investors. They often use many exaggeration and metaphors to emphasize position, and what is said is often not as important as how it is said. Family, friends and connections are very important. They do business with people,

not companies, and they make commitments to people, not contracts. Therefore, it is no wonder that they expect the Obegi family to serve them as well as they can, since from their side, they remain loyal clients. When they open investment accounts, they expect to be offered services that very often differ from those expected by usual investors. When something goes wrong (at the portfolio performance level), they often feel offended and do not accept losses.

BEMO investors are most of the time people who have accumulated their wealth over time and generations. They manage the latter in a paternalistic way. Most are rather mature business persons, and are relatively old. The problem we encountered was their lack of investment know how.

4.2.1 Personnel qualifications

The attitude and behavior we have needed and consequently decided to adopt have the following characteristics:

- A more conservative approach to portfolio management
- Patience, as extensive explanations were needed. We also made it a rule to check whether the client had understood all aspects of the investments they were engaging in.
- Recognition that people and relationships matter more than the job, company, or contract
- Avoidance of expressing doubts or criticism

We finally made clear that the key to surmount problems we had was the structural changes needed to ensure financial advisors were technically qualified, and had high ethical standards.

4.2.2 Procedural changes

In order to have a good implementation of the restructuring plan, we took the initiative of suggesting new procedures.

As interpersonal communication plays a crucial in the financial advisory, it is very important to tighten recruitment rules, at the filtering and screening phases. The human resources team should, in accordance with the FMD Financial Markets Division head, look for candidates who would have a careful and ethical advisor profile rather than a salesman one. It definitely should

choose someone with communication skills, but not at the expense of choosing someone with a lack of interpersonal skills. Candidates should also have a good educational background, as this would ensure they have a basic technical know how. High specialization levels need to be reached with time.

Also, we mentioned the problem most private banks face: high turnover. For Middle Eastern private banks, this problem's consequences are heavier. The reason is that clients, as we mentioned earlier, value relationship management. Since turnover is high, they end up having different interlocutors over time. A factor aggravating the situation is the slow redistribution of their portfolios. For that reason, we highlighted the fact that Management needed not to allow that clients find themselves with no financial advisor in the middle of the client redistribution process.

A final recommendation we made was the need for a head. Over the past two years, BEMO has not have a Financial Markets Division head, and mainly relied on senior financial advisors to run the show. Although these meet all the requirements to manage the team, rule enforcement often lack due to the unclear authority lines. This proved to result in poor advisory performance.

Other than the changes needed at the unit level, behaviors and attitudes must be reviewed at the personal level. As this study intends to show, ethics in financial advisors' behavior and attitude are very important. To enable the latter to respect ethics guidelines, management should enact and follow up the implementation of a detailed Code of Behavior, while making sure the Code of Ethics is respected at all times.

Among the main points highlighted were the need to systematically ensure advisors' active listening, ethical advising and transparency (e.g: periodical reminder about communication fees, especially when those changed).

Conclusion

If clientele loyalty is to be maintained, high ethics standards are a must. Since these often look absent – especially whenever misunderstandings about transactions occur- it is of utmost importance to set the advising rules beforehand. A tool to reach this target is to enhance the procedures used to determine the clients' investor profiles, as successful relationship

management is based on financial advisor' acknowledgement of his clients' investment preferences, needs and wants.

Chapter 5 Ethics and Responsibility

The financial institution sector is one that interacts with public wealth. By the mere fact that it collects funds and places them in financial assets, or channels them to third parties, it bears several responsibilities towards the whole economy.

In order to protect financial institutions' clients, various acts, laws, rules and regulations have been enacted. Among the principal initiatives aiming at protecting clients is the Consumer Protection Law. The latter is a form of government regulation which protects the interests of consumers. It is therefore linked to the idea of consumer rights. Although it is considered as part of the public law, it highly interacts, even regulates private law. Of relevance to our topic, it includes clauses determining unfair business practices, fraud, misrepresentation and consumer/business interactions. However, despite the fact that this law is extensive on consumer protection, there have been violations of clients' moral rights, and very often these were not proven to be legally wrong.

5.1 Theories in practice

As it has been mentioned earlier, business ethics is a study of moral right and wrong that concentrates on moral standards that apply to business institutions, organizations, and behavior. It relates to the traditional view of moral corporate responsibility, and thus involves those who knowingly and freely order, advise, or encourage what is necessary to produce the corporate act. Consequently when conflicts occurred, proofs have been found that several parties -at different levels- were responsible and needed to be held accountable.

Utilitarianism advocates that the right course of action is the one that would have the most beneficial consequences. Its principle assumes that all the benefits and costs of an action can be measured on a common numerical scale and then added or subtracted from each other; and holds that an action is right if it produces the most utility for *all* persons affected by the action. Where

financial institutions used this *consequentialist* approach, they have often forgotten to take into account both the immediate and all foreseeable future costs and benefits that each alternative would have provided for their clients; as well as other significant indirect effects. They repeatedly opted for the alternative that produced the greatest sum total of utility and chose it to be the ethically appropriate course of action.

Although utilitarianism fitted nicely with efficiency, it showed great incoherence with rights concepts and justice. Financial institutions should have opted to look further into moral rights, since these were tightly correlated with duties. They would have respected clients' autonomy and equality -in the free pursuit of their interests-, and they would have used these rights as a basis for justifying their actions and for protecting -while serving- their clients.

Moral rights, unlike legal rights, are usually thought of as being universal as they are rights that all human beings possess to an equal extent simply by virtue of being human beings. They imply no preferential treatments, hence, no unfairness; and they are tightly correlated with duties. Because moral rights have these features, they provide different bases for making moral judgments from utilitarian standards.

Contractual rights are also important to mention, as these complement moral rights. At this level, enhancement of financial advisors' duties towards clients were needed, as these attached to *specific* individuals, clients, and the correlative duties were imposed only on other *specific* individuals, financial institutions/advisors.

Ethics correlations

As Kant's reformulation states: "*Do unto others as you would have them do unto you*", it is imperative to treat clients as an end rather than just means. Although their liquidity/savings/deposits are the fuel for the economic efficiency, it is to be remembered that they are entitled to have their rights respected and always brought forward. It could be thought that even if this condition was not respected, trust would not fade away, and that their input would not diminish. However, recent events showed that harm lead to extreme conservatism, and that those who used to be periodical injectors ended up getting out of the circle, which lead to a serious escalation of systemic problems.

Finally, justice and fairness concepts are concerned with the comparative treatment given to the members of a group when benefits and burdens are distributed, when rules and laws are administered, and when people are punished for the wrongs they have done or compensated for the wrongs they have suffered. These also appeared to have key roles since their absence undermined long lasting clientele relationships.

Despite the fact that there are many objections to ethics' interference in business, and that they should be limited to obeying the law, by the mere evidence that law does not always coincide with morality, ethics have been proven to be a crucial element in institutions behaviors, attitudes and acts.

Limitation of the study

Although the included information depicted the problems of ethics noticed at the different scales of financial industry, it is to be noted that it is inclusive of only major lacks of ethics that have been predominant in the subprime crisis. Furthermore, and in order to narrow the scope of the research, the studied sample has aimed at generalizing the unawareness of risk in the Levant region, however it has been limited to an effective of a hundred investors.

A last constraint to be taken into account is the fact that the provided information has been limited to the disclosure extent permitted by the bank.

5.2 Financial Advisory Unit Management

This study has been focusing on Ethics in Financial Institutions, and particularly on Financial Advisory performances while advising in investment portfolio transactions. The objective has been to demonstrate that in situations whether of crises or prosperity, clients, or investors tend to suffer from unethical business practices. In light of the recent market downturn, many investors unfairly saw their holdings being wiped out. Other than the fact they had to undergo the systemic crisis, some have found themselves exposed to additional injustice, as they were more exposed to risks than they ever wanted or expected. The reason was simple: they were not aware of the riskiness of their portfolio investments.

5.2.1 Management approach

Different situations and conditions require different management approaches. In our situation, management, in order to run the business effectively and fulfill the promise the bank made to its clients, has to ensure due care and diligence relatively to how it protects their rights and advises them.

Since BEMO's primary tool towards providing its clients with full satisfaction is its Relationship Banking structure, Financial Advisors form the pillar of its strategy. They are expected to assess and understand customer needs, provide them with advice on their business and personal needs, and act as their primary contact. BEMO promises its clientele to have a personal "financial partner" who can discretely advise them on balancing their overall wealth management strategy while respecting their risk appetite and financial preferences. Furthermore, BEMO always focuses on its motto: "BEMO, a bank with ethics". It is therefore a must to plan a system where Financial Advisors will be available for consultation at all times and will continuously monitor clients' holdings and fine-tune their financial strategy to meet their changing needs. An existing service that will need to be enhanced is the periodical client notification of their portfolio performance and of any significant financial or economic developments that affect it.

Management will need to outline in detail the style or approach that works best under these circumstances, and as we will see below, its practices will have to be consistent with the requirements of the external environment, technology, and capabilities of the financial advisory team involved.

Conflict of interest

The reform will have to deal with the prominent danger this kind of profession faces: conflict of interest. In this case, it is not a matter of personal ethics. It often results from the structural features of the financial advisory profession, and therefore requires to be managed through carefully designed systems.

As many means for managing it were found, we mentioned two implementation levels:

- At the Financial Advisory level, relationship managers must ensure they act in respect to the following:

- Objectivity
 - Disclosure and Transparency
 - Independent judgment
- At the Financial Advisory Management level, head of units must make certain that advisors act accordingly to the above mentioned standards, by putting in place the following:
- Rules and Policies
 - Structural Changes
 - Implementation of a system that would avoid situations where an advisor may act in inconformity to the rules and policies. In here, a tight control system was also suggested.

Emphasis on quality

Quality is value performance to establish specifications or standards, excellence, or meeting and/or exceeding customers' expectations. Management needs to emphasize the need *and* importance to achieve customer satisfaction. It therefore needs to determine the norms and standards that will allow the provision of high-quality services, and necessitate to make quality a responsibility of each advisor.

The benefits of such an approach will not only be to satisfy and retain the clientele, but will also enhance the bank's image, will lower the costs usually incurred when there are advisor/client misunderstandings and will eventually higher its market share.

Management Control

As implementation always need to be complemented by control, Management could coordinate their existing KYC (Know Your Customer) and CRM (Client Relationship Management)

procedures, as this could yield significant benefits for the institution. The suggestion was to accord them in a way that would yield a list of control procedures in order to enhance implementation supervisory.

As it has been mentioned earlier, the exclusive focus on sales significantly undermines the potential benefits and overall value that can be gained. This is particularly relevant in the current challenging economic environment, where making the business run as efficiently as possible while doing all that is possible to increase sales is becoming a prerequisite for survival. Consequently, the suggested control procedures aimed at providing a platform for information visibility across the organization, through which unethical budget making practices would be signaled.

By pulling information from compliance, finance, marketing, Personal and Corporate Banking and Trade Finance departments, the management will probably be able to have a clearer picture of how clients' accounts are being processed. It goes without saying that these procedures, thanks to their cross-departmental features, could generate additional benefits, including enhanced financial control, improved forecasting, and in-depth business understanding.

The key to successful interaction remains, therefore, to understand the overall relationship the entire organization has with the client, and to enforce the rules tailor-made to satisfy clients.

Conclusion

Ethics and profitability

Pointing to individual companies in which the pursuit of ethics has existed side by side with the pursuit of profit does not fully demonstrate that ethics is consistent with the pursuit of profits. Furthermore, there are many different ways of defining ethical behavior, many different ways of measuring profit, and many different ways of deciding whose actions count as the actions of the bank.

Despite these difficulties, several studies have examined whether profitability is correlated with ethical behavior. The results have been mixed. Although several studies have found a positive relationship between socially responsible behavior and profitability, a lot have proved that these were not correlated. No studies, however, have found a negative correlation, which would have

indicated that ethics is a drag on profits. We can conclude therefore that ethics does not detract from profit but rather seems to contribute to it.

Management interventionism

As ethics are a means *and* an end, BEMO focus on widening its clientele database should not be a priority relatively to its struggle to enhance the offered services to the existing clientele.

As the study has showed, a better assessment of clients' investor profile is a must. This will require management to improve its communication channels linking the Financial Advisory Unit with the Management decision center. The system should allow a two-way communication in order to convey feedback from financial advisors to management, as this will diminish pressure on budget making when financial markets justify abstention, and will allow a better assessment of clients needs.

Finally, as BEMO aims at building solid relationship with its clients, financial advisors will have to be provided with firmer guidelines on how to interact with their advisees. Advisors' integrity leading to a boost in clientele loyalty, relationship managers will have to develop their clients' risk awareness. Incentives to encourage this change could be included in their career plans. A suggestion to partially base end-of-year bonuses on client satisfaction and portfolio performance was made. However, it is still under review as this may be drawback in bear markets phases.

Advisory Communication

The way advisors communicate with their advisees is often complicated to standardize due to differences in clients' financial knowledge. As this leads to wrong assumptions made by both parties, it is of utmost importance to keep on building clients' awareness from one side, and to support financial advisors' drive to adapt to clients' culture, to exercise due care and to hold high their ethics.

"With great power comes great responsibility"

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