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**“Ethics from Within:
A Paradigm Shift for Financial Ethics”**

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*The opinions expressed in the paper are only mine and do not reflect the view of the organizations mentioned

*“relativity applies to physics, not to ethics”
(Albert Einstein)*



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1. Introduction and Background

Pope Francis in his 2018 address to the Centesimus Annus Pro-Pontifice Foundation (FCAPP) stated that “the ethical dimension of social and economic interaction cannot be imported into social life and activity from without but must arise from within”, adding that we must overcome “the tragic and false dichotomy between the ethical teachings of our religious traditions and the practical concerns of to-day’s business community”.

The simple and inspiring words of the Pontiff point out a distinction between “ethics from within” and “ethics from outside” that is gaining prominence and recognition in the current discussion on ethics in finance. We believe that the concept of “ethics from within” marks a paradigm shift in the approach to financial ethics, and more broadly to business ethics. A fundamental transition is underway, from “ethics from the outside” to “ethics from within”, which has wide-ranging and relevant practical implications for business, regulators, policy-makers and the stakeholders. This shift moves ethical considerations from the periphery to the mainstream of business operations, affecting business plans and models, risk management tools, product and process innovation, profitability, customers’ relations, etc. Therefore, it must be well understood and analysed in depth in relation to the conceptual and policy framework of modern finance.

This is what we aim at in this paper. Drawing on the economic literature, but without pretending exhaustiveness, we discuss the analytical foundations of the conventional approach, which basically views morality as an “economic externality”. We highlight how and why the policy implications of this approach, which we call the “trickle-down hypothesis”, appear unsatisfactory and have been criticized. We then consider an alternative approach, which sees morality fully embedded in the decision-making process of economic agents and in the operation of the market.



Finally, we discuss the practical implications of this conceptual turn, which are quite promising in opening new perspectives and providing guidance to policy reform and business strategies but pose also considerable challenges to established practises and mind-sets based on the conventional theory. These challenges take on a particular significance in the present context of post-crisis normalisation and social polarisation.

The required adjustments are significant and profound. Even though the ethical dimension figures prominently in many specific questions of financial innovation (i.e. cryptocurrencies, cyber-crime and data confidentiality, management compensation, fraud and money laundering, social impact bonds and green finance, corporate governance, moral hazard in bail-outs or sovereign debt, etc.), there should not be a specific ethical problem “inherent” in finance, and there should not be a special financial branch or model that can be considered “ethical” as distinct from -or opposed to- the rest of finance (see Garonna 2016). Reforms therefore should aim at mainstreaming ethical considerations across the whole business operation of the industry, avoiding silos or niche approaches and the stigmatisation of “specific” instruments, such as securitisation, high-frequency trading, shorting and naked put sales or leveraged buy-outs, or more broadly financial innovation. After all, the latest financial crisis, and moral crisis in finance, erupted in one of the most conventional and least advanced compartments, i.e. subprime mortgages. In sum, ethics is a foundation of finance, as much as it is a foundation of all business activities, and as such should be dealt with in relation to the diverse aspects of change and innovation, from digitalisation to market development.

2. Ethics from the Outside: Virtue as an Economic “Externality”

According to conventional neoclassical economics, and mainstream thinking in policy and business circles, “homo oeconomicus” in her decisions is only guided by self-interest. Economic efficiency and welfare



(in terms of “Pareto optimality”) are achieved in a competitive market economy only thanks to the “invisible hand” that reconciles the different and conflicting preferences, conditions, technologies, structures, etc., and creates order and equilibrium out of independent decentralised and selfish decision making. Obviously, it was widely recognised that the outcomes of free market exchanges – albeit optimal from the efficiency point of view- could come out to be socially undesirable or morally unacceptable. This awareness, and the related concern for ethics, has fed a vast stream of literature, and political debate, on how we can guide and constrain the market mechanism to take into consideration social and ethical considerations, thus bridging the gap between private costs and social costs, private benefits and social welfare. This is the so-called “problem of the social cost” (see R.Coase’s seminal paper), of which the ethical costs are part, to which the Chicago School among others devoted a lot of attention. The underlying vision is that many significant factors that do not enter “within” the practical decision making of profit motivated economic agents, such as full information, transaction costs, and moral considerations, appropriately called “externalities”, lie “outside” the market mechanism, and determine its “imperfection” (market failures). Hence, the role of public policy aimed at correcting market imperfections and “internalising” social and ethical considerations into the decision-making processes of economic agents. The tools through which public policy operates are rules and regulation, tax incentives or subsidies, disclosure requirements, controls and supervision, etc. In order to make the market mechanism work for the public good, market imperfections must be corrected through normative and regulatory frameworks, in the context of which ethical and deontological norms and goals play a primary role.

On the basis of this “philosophy”, the response to the last financial crisis, which was essentially a moral crisis, brought about an in-depth re-visitation of micro- and macro-prudential regulation, giving rise to a



wave of global regional and national rules and the strengthening of the supervisory mechanisms (Basel III, MIFID, UCITS, Solvency II, etc.). Capital requirements and liquidity safeguards were made more stringent for banks and insurers, specific norms on money laundering, compliance and risk management were introduced, data protection and cyber-crime legislation were enacted, together with supervisory reforms aimed at greater effectiveness coordination and convergence, etc. It is undeniable that a huge amount of work has been done by policy-makers and regulators, and the world of business and all stakeholders participated to promote compliance and effective implementation of this complex machinery. But is this enough? Does it guarantee more solid moral foundations to finance for the future? Can we feel safe and well-prepared in relation to the next financial crisis? The jury is still out on whether the outcome of all those post-crisis regulatory reforms is satisfactory and will be able to prevent more crises and ethical slippages. The on-going debate on the issue is heated and rather inconclusive (see Geithner, Garonna, 2017, and others). Moreover, the “*vox populi*” is still by-and-large unfavourable, as the gap in the public perception of the ethical standards in finance remains large and worrying.

3. The Limits of the Trickle-down Approach

The main lines of criticism can be summed up as follows. First, the volume and complexity of norms, the baroque and fragmented architecture of regulatory authorities does not make it easy to ensure compliance and a real change in behaviour and mind-sets. A recent paper draws an imaginative analogy (see Haldane, 2012): what makes a dog catch a frisbee? Certainly not a set of complex rules and calculations, such as we have in the world of post-crisis finance. Rather the skilful dog follows simple rules of thumb that make him very effective in achieving its goal. We are far from this in finance. In the Italian Enlightenment, a lot of work went into designing an effective



legislative system. Beccaria synthesized it in a remarkably compact sentence: “Let the laws be clear and simple; let the entire force of the nation be united in their defence” (Beccaria, 1764).

Second, as rules are costly to apply, and may have unintended consequences, the appropriate calibration of the regulatory regime becomes of decisive importance; but it is quite difficult to accomplish. Overregulation may affect profitability or penalise the funding of the real economy, particularly infrastructure and Small and Medium Enterprises - SME (there is a lively discussion on re-calibration in relation to capital requirements and Solvency II). Moreover, compliance costs may become unbearable for small intermediaries, so that “proportionality” clauses must be introduced in favour of small banks, and prudential mechanisms have to be lightened when loans benefit SMEs (the so-called “SME supporting factor”).

Third, changes in regulatory regimes do not follow steady trends, but rather oscillate with cycles of growing and declining regulatory pressures due to changing conditions, politics, innovation and the business cycle. The regulatory regime therefore is not generally stable, but rather subject to trade-offs, dilemmas and the pendulum between under- and over-regulation. Striking the right balance in that pattern and managing the trade-off between innovation/flexibility and regulation/stability appear to be formidable challenges. Take for instance the case of “sand-boxes”, introduced by regulators to enable the experimentation of innovative fintech or big data. They may determine loopholes in the regulatory framework; which explains why some regulators are quite reluctant to contemplate them.

Four, implementation requires effective supervision and - for cross-border operations- equivalence and/or convergence of supervisory practises. Given separate jurisdictions, progress on this front is quite hard. This is one reason why there tends to be much less focus on implementation than on ex-ante regulation. Thus, rules end up working much better in retrospect to face up to the crises of the past, than in



anticipation of those of the future. Ex-post factum, rather than ex-ante, as a prevention tool. And they do not work well by definition when dealing with “unknown unknowns” or tail risks (the so-called black swans).

Finally, the ethics of the regulators themselves can be put in question. It is the classic dilemma of “*quis custodiet custodem?*”. Who supervises the supervisor? Mistrust, formalism and laxness stimulate often “defensive behaviour”, which implies: I do my best to “formally appear” in compliance, but do not care about the substance. This is another manifestation of ethics from outside.

In sum, to expect that an improvement in ethics would simply trickle-down from the operation of a rigorous and well-structured supervisory regime is an unwarranted leap forward. Optimal and second-best supervisory regimes have undoubtedly to be established, and then continuously revised reformed and fine-tuned; this is of fundamental importance also from the ethical standpoint. But their ultimate impact on ethics will inevitably remain ephemeral and undetermined, like an undecipherable phoenix.

4. A More Fundamental Critique: Ethics as an Add-on

So far, we have followed the mainstream approach in the neoclassical economic literature, which corresponds to the mainstream policy approach to ethics in finance, and more broadly in business. This approach implies that the market and their participants (households and business) are “amoral”, or “wert-frei” (Austrian School), as they are driven in their decision making exclusively by profit maximization, and act therefore “a-morally”. In this context, if one wanted to force the market to pursue ethical goals, she would have to act “from the outside”, through public policy, imposing constraints norms and incentives that bridle the animal spirits of the agents and – by distorting their free decisions- induce ethical outcomes. The external intervention is necessary to correct market imperfections (the “immoral” instincts of



the players), bring efficiency in line with policy objectives (ethics), but this could also possibly determine costs and economic losses. We might even say that the more we intervene from the outside, the more we will “correct” the market and promote ethics. Ultimately, we might even speculate that if we replace the market exchanges driven by profit maximisation by exchanges motivated purely by ethical objectives (like in the gift economy or in the third sector, voluntary work, philanthropy, etc.), we will achieve the common good to the maximum extent possible. Here is a possible “rational source” of the wide-spread anti-market and anti-finance prejudice that characterize the public sentiment towards ethics in finance.

Note that in this framework, the ethical standards of market performance depend on the effectiveness of the public policy tools that steer the market, i.e. on “outside” conditions. When such conditions occur, because regulation is rigorous, the right incentives apply, and supervision is effective, we will achieve ethical outcomes, i.e. the market mechanism works for the public good. Otherwise, the market will operate independently of ethical considerations.

An important corollary is that these outside conditions may in general function in parts of the market, parts of the time. In other terms, we could single out “ethical” sectors, products, situations, where special conditions apply. This is the case for instance of the so-called impact investment, or green bonds, or other. By implication, the rest of the market, the rest of the time, would be ethically unaffected or “morally neutral”. The growing concern and demand from the public has stimulated – based on the mainstream approach- in the last period, particularly after the big financial crisis, the development of market “niches” in terms of products or sectors that appear specifically targeted to pursue moral objectives, and put ethics in their mission, brand or flags: i.e. social or impact investment, sustainable insurance, green bonds, corporate social responsibility, ESG (environment, social and governance) criteria, ethical banking, social reporting, etc. Ethics



therefore look confined to a part of finance, not the whole, a fringe of deserving instances, a glittering add-on, which leave the main body and substance of the trade unaffected.

5. The Market as a Social Institution

“Ethics from within” belongs to a different approach, which can be traced back to a long and prestigious tradition in the history of economic thinking. We may refer in the economic literature to the classics (Adam Smith and Ricardo), S. Thomas Aquinas and Aristotle (see Hirschfeld 2018), but there have been more recently a set of innovative contributions. To illustrate it, I will mention two significant contributions: that of Robert Solow in his 1990’s book “The market as a social institution”, and that of Amartya Sen in his 1987 essay “On Ethics and Economics”.

Solow focuses on the labour market because of its fundamental role in macroeconomic equilibrium. Moreover, the labour market is where the mainstream neoclassical approach has the greatest difficulty in reconciling theory with reality. Solow argues that the labour market is a special case, cannot be treated like all other markets. The reason is that in the labour market the relationship between the ethical dimension and the operation of the market has to be turned upside down. Unlike other markets and other commodities, the market for labour appears totally embedded in a moral dimension. In this special market, economic players, buyers and sellers, are “moral individuals”, who carry moral aspirations and reach equilibrium positions reflecting an ethical order. Immorality/morality therefore are not simply situations of market equilibrium resulting from an intervention “from the outside” that corrects or promotes the market. But they are “inherent” dimensions of the market as an institution. In other terms, the market itself is a “moral” or “social” institution.

Sen in his book extends Solow’s argument to the whole market and all markets. He argues that “since the actual behaviour of human beings is



affected by ethical consideration, and influencing human conduct is a central aspect of ethics, welfare economics considerations must be allowed to have some impact on actual behaviour". In other terms ethics enters into market decision-making and shapes behaviour, inputs, outputs and economic performance "from within", quite independently of the policy or regulatory constraints and incentives.

This line of reasoning, which was further enriched and developed by economists of the calibre of Karl Polanyi or George Stigler represents a radical departure from conventional thinking and has profound implications for analysis and policy prescriptions. Later, behavioural economists and institutionalists or neo-institutionalists contribute significantly to the approach. When ethics works "from within", it becomes difficult to single out specific compartments or situations of the business that are "ethical" as opposed to others that are "unethical" or "ethically neutral". It is not a question of black and white, or green versus brown, but rather an issue of degrees and shades, and of the specific ethical features of a market (the quality of the market). The market itself, and the whole market economy, is an ethical construction, and ethics is part of capital (the social capital) and investment. Ethics thus reaches into the heart of the business model, the sources of competitiveness and performance, the tools and grades of risk management, the secrets of profitability and customers' satisfaction. Ultimately the market itself has an ethos (see L.Bruni, 2012). It is a community. It is founded on a set of values. Therefore, it is "moral" and well-functioning, or alternatively it is immoral and dysfunctional. It cannot be "a-moral" or ethically neutral. Well known applications of this approach are M. Morishima's study of the Japanese performance in the 1980's based on "Japanese values", and Ronald Dore's explanation of the East Asian miracle linked to Confucian ethics.

6. Moving Ethics from the Periphery to the Mainstream of Business Operations



The paradigm shift from ethics from outside to ethics from within has meant a quantum change in the approach to the topic from the business perspective. While before ethics was important only in a few departments of the business organisation, such as public relations or institutional relations, communication, branding and advertising, or the legal office for compliance, now increasingly the whole organisation is at stake starting from the board-room and the CEO, to risk managers, product developers and innovators, quality control, to the shop floor, etc. Ethics feed the “culture” and the *geist* of the company, its inner identity, its vision of the future, its management style and leadership. This shift has brought not only new perspectives, insightful academic contributions and fresh business opportunities, but also new challenges. I will run through a few of them.

- **Demarcations and Taxonomies: The Case of the “Green Supporting Factor”.**

Using legal and administrative tools to draw the line between what is morally positive and what is negative is a complex matter, increasingly so. But it is necessary if one wants to use policy tools to promote ethics “from the outside”. Take for instance the current debate on the so-called “sustainable finance” or green finance, which is gaining increasing attention and support from business and policy circles. There are several proposals on the table aimed at introducing public incentives, such as tax rebates or less stringent capital requirements. The goal is to promote an environmental-friendlier attitude towards investment, and channel savings towards worthy causes from the point of view of ESG (environment, social and governance). At the EU, the topic is dealt with in the context of the ambitious programme of Capital Markets Union (CMU), of which the promotion of sustainable finance is seen as a fundamental pillar. While there seems to be a growing political will to provide such incentives (e.g. Italian banks are strong supporters of the so called “green supporting factor”), there are also resistance and



hesitations at the technical level, because it is recognised that it is difficult to discriminate between what is green and what is not. Where do we draw the line? There are many intermediate situations, where ethical considerations do play a relevant role. Is the whole non-renewable energy sector out of the scope of such incentives? Or should we not instead incentivize also clean coal, carbon capture and storage, and energy efficiency? In order to make progress and anchor the policy debate to objective non-ideological guide-posts, the European Commission has promoted technical work to define a taxonomy of sustainable activities, aimed at classifying financial activities on a sustainability scale, in a rigorous and widely recognised way. This is nowadays one of the main, and most challenging, task in the CMU programme, representing a pre-condition for enacting policy measures, such as the so-called “green supporting factor” (GSF). The GSF would be a more favourable treatment of targeted “green assets” from the point of view of prudential regulation. Italian banks among others in Europe strongly support the introduction of such a factor. However, if a sharp and uncontroversial border line is not found, political support for the measure could falter. The EC is also studying the possibility of defining a set of indicators to facilitate benchmarking and ranking assets in relation to sustainability and encourage peer pressure and reviews. A rough, but simple rule of thumb was found in Italian legislation (and elsewhere) by defining and incentivising long-term savings and investment, as a special case or proxy for sustainable investment. In Italy this proved quite successful when tax incentives were introduced for long-term “individual savings plans” (PIR). Picking and choosing “from the outside” a specific asset class of green- social – ethical investment is proving to be increasingly difficult and controversial. A possible alternative or complementary strategy is to promote from within an evaluation of assets/liabilities that incorporates the ethical dimension (e.g. through ethical codes of conduct).



7. Moral Disengagement: The Disease of Our Time.

It is a global phenomenon, related to what Pope Francis has often called the “globalisation of indifference”. It can take different forms in different contexts and manifest itself both in individual and collective behaviour. “How can we do bad and live well?”: this is the basic question that a fascinating and promising stream of research is addressing (see A. Bandura 2016). It brings together cognitive science, biology, psychoanalysis and economics. It goes deep into the “inner sides” of ethics, unveiling sometimes its darkest sides. What makes it possible that human civilized prosperous individuals, and societies, become responsible of crime, cruelty, persecution, violence, down to genocide and humanitarian tragedies. The answer lies in the mechanisms that produce moral disengagement, and by contrast moral engagement. The literature has identified and analysed such mechanisms: e.g. dehumanization of the victims, buck-passing of guilt, minimization neglect or falsification of consequences, moral justifications, search for scapegoats, etc. It is important to note that those mechanisms operate through self-regulation and can only be produced “from within”. It is impossible to govern behaviour, and society, only by “the control of fear”. “A civil society is predominantly a self-regulating society”, and morality is governed “socially” (Bandura op. cit.). Like the “common good”, the “common bad” can be produced by deliberate and targeted efforts aimed at moral disengagement, i.e. neutralising the ethical checks and balances, rewards and stigmas that regulate (or better self-regulate) individual and collective behaviour. Moral disengagement is a slow and pervasive process that follows gradual steps and delivers its poisonous lymph through often unperceived and innocuous-looking mechanisms. Any resemblance to real events and/or real persons is not purely coincidental. I believe in fact that dangerous processes of moral disengagement are underway in our dismal times in politics and society. More in-depth investigation would be required if we want to stop going down the disengagement slide, or better turn it into a moral



engagement strategy. What is encouraging is the fact that in the course of history humanity has shown an extraordinary capacity to contain counteract and recover from disengagement and its potentially devastating consequences. But it has required a determined and targeted investment in ethics at 360°. Ethics from within.

8. Economic Incentives and Integrity: How to Create an Ethically Resilient Civic Culture.

Ethical concerns have increasingly brought about the deployment of economic and material incentives in public policies, legal systems and organizational structures, aimed at fostering performance, productivity, compliance with social and ethical norms. This occurs in relation to fiduciary duties in financial management, performance-related pay, customers' satisfaction, ESG reporting, etc. Are these efforts efficient and cost-effective? Are they enough to produce the desired ethical outcomes? Some authors suggest that they may be counter-productive (see S. Bowles, 2016): "Good incentives are no substitute for good citizens". Bowles quotes the case of the Haifa's day-care centres, where a fine was introduced to discourage parents' lateness in picking up children. Parents responded to the fine by doubling the fraction of time they arrived late, and when the fine was revoked, the parents' tardiness persisted. The moral of the story is that economic incentives for ethical purposes can only work to a certain extent: if monetary incentives undermine "social values" and the ethical motives that "normally" drive individual behaviour, they may become counterproductive and cause a permanent damage to the social fabric of a market economy. The question then becomes: how we foster a society that sustain a robust civic culture of cooperation, solidarity and integrity?

9. The Moral Cancer of the Social Market Economy

If we look at the market economy and finance "from the inside", as a set of moral institutions, what do we see? The picture we get from a recent



book by two heavy weights in economic thinking, Akerlof and Shiller, is harsh merciless and worrying. The market economy in its normal operation appears full of deception trickery and manipulation. Economic agents exploit all opportunities for taking advantage in the name of profit of widespread vulnerabilities of customers and citizens, sell products for which there is no real need, make people pay too much for it, develop addiction and fear, etc. At the cost of generating bubbles, bankruptcies, unemployment, and at the risk of damaging health, the environment and the quality of life. Please note that the two economists, Nobel Prize winners, are not radical agitators, but serious academics, who aim at moving forward the frontier of economic theory, correct and improve behavioural economics, challenge the role of revealed preferences and equilibrium in conventional macroeconomics (as they explain in an Appendix to their book). The outcome is a dismal description of the state of the economy, affected by a “moral decease”, which they assimilate to a “cancer from within”, rather than a virus or an infection that can be cured with drugs or surgery from the outside. “Phishing for phools”, as they imaginatively call it, i.e. the opportunistic behaviour of market participants aimed at deceiving and manipulating naïve customers, corresponds to a state of “equilibrium” that reflect a widespread vulnerability of people involved in market transactions, subject to cognitive obstacles and the unscrupulous pitch of profit seeking agents. In the backdrop, we have a society where “the mass of men lead lives of quiet desperation”, as Henry David Thoreau put it in 1910.

The troubling reality confronting us is that financial analysts and economists were totally unable to anticipate and understand the last crisis, and still do not have – based on conventional thinking- credible explanations and prescriptions to prevent the next one coming. Why? First, the moral crisis is seen as caused by a few crooks, knaves and fraudsters, which regulation sanctions and prosecution can neutralise and bring to justice. The fact is instead that the market itself,



irrespective of the moral fibre of specific individuals, has acquired a built-in capacity to act opportunistically, so that under competitive pressures “any person” would normally engage in “phishing”, i.e. in profit-motivated deception and malpractice.

Second, moral breaches are generally attributed to imperfections of competitive markets (externalities), characterized by asymmetric information, monopolistic competition, and other forms of market failures. Those failures once again can be corrected “from the outside” by policy and regulation. But, in reality, even correcting for those failures, the question of the ethical foundations of the market remains, and if not directly tackled would have serious consequences.

Third, politics itself, and policymakers, is part of the same game and participate in the “phishing equilibrium”. Politicians exploit weaknesses of the public to gain consensus and “sell” them things that they do not need while jeopardising citizens’ well-being.

To get away from the economics of deception and manipulation we need a long-term commitment to strengthen the moral fabric of free markets and business communities. This aspect is neglected by Akerlof and Shiller, but in my view should be added and focused on. Integrity is not only an attribute of individuals (consumers or producers), but of the market itself as an institution. The moral economy can develop dangerous moral deceases from within that turn it towards corruption and immorality. It takes a deliberate and responsible effort to gradually strengthen business ethics and build a robust ethical capital.

10. Conclusions

The examples surveyed above, among others, show how much more work is needed, both analytically, politically and in business cultures, to make “ethics from within” a reality and strengthen the social capital of the economy.

The purpose of this paper was to elaborate further on the insightful and inspiring indication from Pope Francis that “ ... the ethical dimension of



social and economic interaction cannot be imported into social life and activity from without but must arise from within. This is ... a long-term goal requiring the commitment of all persons and institutions within society”.

Focusing on “ethics from within” both in terms of analytical foundations and practical implications has shown that a true revolution is underway in business ethics, particularly in the world of finance (more on this in Garonna, op. cit.), and that much more dialogue, discussion and research - of the kind that the FCAPP within the so-called Dublin Group is carrying forward- is needed.

The quote from Pope Francis echoes the encyclical **Caritas in Veritate**, where we find a clear statement providing guidance in this research and dialogue programme:

“Efforts are needed ...not only to create “ethical sectors” or segments of the economy or the world of finance, but to ensure that the whole economy – the whole of finance – is ethical, not merely by virtue of an external label, but by its respect for requirements intrinsic to its very nature.”

Such efforts must be targeted at developing ethical codes and codes of conduct at 360°, informing advocating and training employees, employers and managers, educating consumers the media and professionals, mobilising ethical committees in companies, public offices, non-governmental organizations, business associations and stakeholders’ groups, engaging the general public and policymakers.

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