Ethics and the financial system – extending the themes of the Vatican's 2018 letter, and lessons for educators and professional development

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Abstract

The 2018 Vatican letter on the financial system helped develop Catholic social teaching in the area of finance and the economy. A substantial part of the letter was devoted to the importance of ethics in economic life. This is an important message. It is argued in this paper that, as social teaching in this field develops further, there should be more focus on the importance and development of the virtues. These can be taught and formed in the home, in schools, in universities and in professional development courses. The letter reaffirmed earlier teaching on the need for regulation. Further consideration might lead us to question the efficacy of statutory regulation, and especially international regulation. However, there are many bodies other than government that can regulate markets and Catholic social teaching has a long history of emphasising the importance of such institutions: this is another theme for further development.

Introduction

The recent Vatican letter, *Considerations for an ethical discernment regarding some aspects of the present economic-financial system*'[1], examined the relationship between ethics and economics in the context of contemporary issues in finance. It was a contribution to the reflection that has been taking place about these issues since the financial crisis. It also marked a continuation of the development of Catholic social teaching in this area building, for example, on *Caritas in Veritate,* issued by Pope Benedict XVI in 2009.

This paper begins by discussing the importance of ethics in economics. It then considers the importance of the key messages in the early parts of the Vatican's 2018 letter. It is argued, both in this paper and in the letter that, whilst economists may wish to pursue certain questions and lines of inquiry without reference to normative ethics, a rounded treatment of economics and finance demands a consideration of ethical questions. As such, Catholic social teaching in this area is of crucial importance.

A number of areas in which the themes of this part of the letter could be further developed in future work on Catholic social thought are identified. The first is the importance of the practice of the virtues in economic life. Whilst the word "virtue" does not appear in the letter, the underlying importance of the virtues is not entirely ignored. However, it could be argued that a full and explicit consideration of the practice of the virtues would help to unify various aspects of the message.

The Vatican's letter moves on to discuss a range of practical issues to do with financial markets and their regulation. Such discussion is legitimate in the corpus of the teaching of the Catholic Church. However, this paper argues that some of the questions raised would also benefit from more reflection on the importance of virtue

[1] This is a long title in the English language version and it will be described as the "Vatican's 2018 letter" or "The Vatican's 2018 letter on the financial system" or simply "the letter" below.

ethics in this context also, including in teaching and professional development. In addition, when it comes to regulation of the financial system, further consideration of the nature of the human person and the proneness to frailty of human persons in all contexts in which they operate might have led to different conclusions about the efficacy of government regulation. In turn, this should lead to an investigation of the possibilities for regulating financial market activity through market institutions and institutions of civil society. Such institutions have been important in a number of countries at different times in history and are strongly emphasised in other areas of Catholic social teaching.

The difficult of perfecting, or even improving, market outcomes through statutory regulation then takes us back to a consideration of the importance of virtues in dealing with the specific problems that arise from financial innovation. The virtues are also needed when it comes to determining whether regulation is the right approach to dealing with problems that arise from innovation and, if so, what type of regulation is appropriate. Virtue in public life can help legislators reach better solutions. The importance of virtue in public life, a key feature of the tradition of Catholic social teaching, should be taught in politics and citizenship courses. In addition, an understanding of disciplines such as public choice economics will help us appreciate the limitations of government action based on a realistic interpretation of the nature of the human person.

Implementation and further development of the themes of the letter requires knowledge of various strands of economics, political economy, finance, philosophy and virtue ethics. Indeed, the letter makes an important point at the very beginning: "[A] synthesis of technical knowledge and human wisdom is essential. Without such a synthesis, every human activity tends to deteriorate. But where it exists, it can foster progress towards the integral and concrete well-being of the human person." (1) To use academic jargon, a truly inter-disciplinary approach is necessary when thinking about how financial markets can operate for the common good and how people should operate within them.

The domain of ethics in economics

The importance of finance

The financial sector has frequently comes under attack and scrutiny has intensified since the financial crisis. Lord Turner, who was Chairman of the financial regulator (the Financial Services Authority) in the UK from 2008-2013, claimed that much of what went on in the financial sector was 'socially useless'. His report, Turner (2009), mentioned a number of the concerns later raised in the Vatican's 2018 letter.

One of the reasons why the financial sector comes under attack, even when it seems to be performing well, is that the purposes of financial institutions are difficult to understand because what it produces is not tangible. The sector makes possible forms of economic activity that would not otherwise be possible. Without banking[2], all economic exchange would have to be facilitated through barter or a commodity money such as gold. The financial sector provides households with a secure place to save in a way which hugely reduces risks and the costs of assessing potential borrowers whilst simultaneously ensuring that individuals and businesses can borrow to buy houses, finance business operations, and so on. Furthermore, in most situations, businesses

[2] Or related institutions such as money market mutual funds.

can borrow over a long time period whilst households that save can access their capital instantly. Without these functions being performed efficiently, much real economic activity would be impossible. Given this, perhaps it was not surprising that the Vatican's 2018 letter suggested that: "Here financial activity exhibits its primary vocation of service to the real economy" (16).

However, the financial sector does not just exist to serve the real economy. Without a thriving financial sector only the very wealthy or those who had very strong family ties would be able to retire. The financial sector allows people to invest in a diversified range of companies, reducing the transactions costs of analysing those companies for creditworthiness and their long-term ability to thrive, thus facilitating pensions saving and retirement. Without insurance, people would live in fear of their home being destroyed: insurance companies pool risks, thus benefiting people on ordinary incomes who could not afford the financial catastrophe that arises from insurable events. So, the financial sector has intrinsic functions too.

Choosing ends and means

Neither the Vatican's 2018 letter nor the 2009 papal encyclical *Caritas in Veritate* dismiss the financial sector as such. But they do highlight the need for ethical behaviour in the sector. This was put very succinctly by Pope Benedict XVI in *Caritas in Veritate*, 36):

> Economy and finance, as instruments, can be used badly when those at the helm are motivated by purely selfish ends. Instruments that are good in themselves can thereby be transformed into harmful ones. But it is man's darkened reason that produces these consequences, not the instrument per se. Therefore it is not the instrument that must be called to account, but individuals, their moral conscience and their personal and social responsibility.

Of course, finance is only a subset of wider economic activity and thus reference to ethics in finance should lead us to consider the wider question of ethics in economic life more generally.[3]

Many schools of economics have tended to separate economics from ethics in the last century or so[4]. An aspect of this tendency has been the trend for economic modelling to become more abstract and mathematical. However, Professor Lord Robbins, who was one of the greatest historians of economic thought of the 20th century, *did* stress that economics involved the study of human behaviour. Specifically, in Robbins (1932), he defined economics as: "the science which studies human behaviour as a relationship between ends and scarce means which have alternative uses". Robbins, of course, was influenced by the Austrian school which would tend to define economics as the study of purposeful human action in the economic sphere.

[3] There is an excellent discussion of economic technique and its relationship with ethical reasoning in Yuengert (2004). It is a short book which would make excellent reading material for an undergraduate PPE course or for any teacher of economics.

[4] For example, Keynes encouraged a focus on aggregate variables rather than on personal action. The Chicago school has tended to narrow the focus of economics to non-ethical questions, though it has pioneered the study of crime, the family and so on, but through a positivist lens.

Robbins' definition, which is widely used in high school and undergraduate economics courses, immediately raises questions about ethics, again very eloquently discussed by Yuengert (2004).

Firstly, we can say that, as soon as "human" and "action" or "behaviour" appear in the same sentence, ethics cannot be ignored. As Pope Benedict put it in *Caritas in Veritate: 'every economic decision has a moral consequence' (CV 37, italics in original).* Separating ethics from economics is like separating ethics from sex and teaching about sex purely through biology. It is for this reason that the development of Church teaching on ethics in economic life is so important.

There is an ethical aspect to all economic questions which should clearly be a subject of the Church's social teaching through documents such as the Vatican's 2018 letter. The ethical dimension of economics should also be the subject of teaching within schools, colleges and universities, though that is not to say that there is not also a place for studying specific technical and empirical aspects of economics and sometimes separating such study from the study of ethics.

Economic action involves the choice of ends. For example, a business owner may choose between maximising owner-value measured in financial terms without reference to any other considerations or may choose to pursue other ends too. An individual within a family may choose to work as long as possible to earn as much money as possible without taking into account the needs of their family or they may pursue a wider range of ends. These are decisions about chosen ends about which ethics has something to say.[5]

The choice of means should also involve ethical discernment. A particular business might have a perfectly satisfactory chosen set of ends such as making a profit whilst treating its employees justly, but choose means to meet those ends that are morally problematic – such as by selling pornography. On the other hand, another business with the same ends, might choose to meet those ends by selling alcohol or operating in the financial sector. These are activities which are not intrinsically immoral but which could be in certain circumstances (for example, if marketing of alcoholic products of an especially addictive type were aimed at young people).

Further ethical dimensions are revealed when we consider the intent of actions in the economic sphere. For example, if by creating a complex securitisation product in financial markets we intend to provide cheaper mortgages for families, that would not seem to be morally problematic even if some people did not understand the product and, as a result, made some minor financial loss[6]. If, instead, our intention is to create a product that others do not understand and thereby make money from selling it knowing that large numbers or people would make large losses, that is morally problematic. An example of this is given in the Vatican's 2018 letter (17): "What is morally unacceptable is not simply to profit, but rather to avail oneself of an inequality

[5] It is important to note, and, once again, Yuengert is excellent on this point, that it is important to follow through this reasoning to consider ultimate ends and ultimate decision makers. For example, money is rarely an end in itself – it is the goods that are bought that are ends (except for a miser). At the same time, the business owners might maximise financial owner-value in order to give away the money to development projects and so the owner might not be maximising the financial value of the business for his own ends.

[6] I have described a situation where the intention is good and there are some unfortunate by-products of the action. The intention might be good, but the outcome terrible. In this case, acting with prudence should make people think twice before marketing such a product.

for one's own advantage, in order to create enormous profits that are damaging to others".

These basic questions of ethics in economic life to do with ends, means and intent are crucial questions that should be considered by parents bringing up children, other educators, businesses developing management training programmes and so on. In some cases, there will not be straight answers to questions relating to ethics in economic life and the integration of technical knowledge and human wisdom is important in making judgements as is noted in the first paragraph of the Vatican's 2018 letter.

It should be noted that economists do not entirely ignore ethical issues, but they tend to treat them in a positivist framework (looking at empirical outcomes) rather than in a normative framework (looking at how people ought to behave). This could be regarded as a reasonable division of labour between the economist and the ethicist, though Yuengert (2004) questions this. One example of an economist considering the practical effects of ethics is given by Nobel Prize winner Kenneth Arrow (Arrow, 1972). He said: "Virtually every commercial transaction has within itself an element of trust…It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence." Interestingly, considering the problem from the perspective of a theologian, Pope Benedict made a remarkably similar comment in *Caritas in Veritate* (17) in which he said: *"Without internal forms of solidarity and mutual trust, the market cannot completely fulfil its proper economic function"* (emphasis in original).

The Vatican letter and ethics – continuity in Church teaching

Given the above discussion, we would expect ethics in economic life to have formed part of the Catholic Church's teaching throughout history. This is the case[7]. The Vatican's 2018 letter builds on the earlier teaching.

The letter states that ethical practice must begin with a personal choice between right and wrong: "It must be noted that the systems that give life to the markets…are in fact founded on relationships that involve the freedom of individual human beings. It is evident therefore that the economy, like every other sphere of human action, 'needs ethics in order to function correctly — not any ethics whatsoever, but an ethics which is people-centred'" (8). The letter then further notes (23) that freedom ought to be oriented towards the good and the true if the common good is to be promoted.

The letter (especially 8-11) also states that economic activity has a relational character: it is not just about goods and services being exchanged. This provides a further justification for not separating economics from ethics. The letter describes the importance of measures of economic success other than the pure material and also the importance of thinking beyond the short term.

Of course, when businesses describe practices as ethical it does follow that they are. There is a danger of consumers being lulled by "window dressing" through programmes of corporate social responsibility[8]. To create a truly ethical business

[7] See, for example, *Rerum Novarum, Quadragesimo Anno, Centesimus Annus* (e.g. 39) and Pontifical Council for Justice and Peace (2004), especially 270-374 (*The Compendium)*. Interestingly, however, in the paragraphs on the financial sector in *The Compendium*, ethics is not mentioned.

[8] See also *Caritas in Veritate* (45) which makes the complementary point that not describing a business explicitly as "ethically" does not mean that it is not so.

sector, there has to be a wide acceptance of normative ethical principles in society. Teaching, formation and professional development needs to be part of this. In many secular places of education, the teaching of business ethics can be difficult because of the desire not to impose one particular ethical way of thinking. However, all universities and colleges, and especially those of a Christian character, should take seriously the exhortation: "it is particularly desirable that institutions such as universities and business schools both foresee and provide…a formational dimension that educates the students to understand economics and finance in the light of a vision of the totality of the human person…. An ethics is needed to design such formation." (10)

The Vatican letter ends paragraph 11 by quoting the *golden rule*: "An enduring call to acknowledge the human quality of generosity comes from the rule formulated by Jesus in the Gospel, called the golden rule, which invites us to do to others what we would like them to do for us (cf. Mt 7, 12; Lk 6, 31)."

Ensuring that ethical reasoning underlies economic decisions is a crucial aspect of promoting the economic components of the common good. However, perhaps more importantly, the injection of ethics into economic decision-making is crucial for promoting the common good as the term is understood more broadly and as it would have been understood in the nineteenth century: that is moving society to a higher state of virtue. Ethics in economic life not only leads to better economic outcomes but also to better social relationships within economic life.

The place of the virtues and culture – under-explored themes

As noted, paragraph 10 of the mentions a "formational dimension" of education. This is needed especially because of the importance of the practice of the virtues. Virtue is not mentioned in the letter which is surprising because the practice of the virtues is a crucial aspect of promoting ethical choices in financial markets in relation to both means and ends[9]. The practice of the virtues needs careful discernment and is especially difficult in situations where the culture is not encouraging of ethical behaviour. Formation through early education and in the home is therefore an important first step and should be a continuing process through university and executive education.

Virtues were very much stressed as a theme in the commentary on the financial crisis by Cardinal Vincent Nichols (see, for example his introduction to Booth (ed) (2010) as well as Bishops' Conference of England and Wales (2010), published before the general election). The relational aspect of economic activity immediately signals the need for the practice of virtues such as temperance[10]. People should behave in the economic sphere with restraint, humility, and modesty; they should exhibit forgiveness and be careful not to retaliate and bear grudges; they should not believe that somebody else doing something wrong justifies their doing something wrong. This virtue can be practised, for example, when we interact with colleagues and direct reports in the workplace or even when we interact with those serving us in retail outlets.

Arrow's comment on trust and economic outcomes has been mentioned above. It is also worth noting that the mottos of both the London Stock Exchange and the Baltic

[9] By contrast, the word "virtue" appears 15 times in *Rerum Novarum.*

[10] Also courage and prudence as will be discussed later, but these are perhaps more important in a different context.

Exchange in the UK have been, for a long time, "my word is my bond". The specific virtue that is needed to ensure that trust is paramount in dealings in financial markets is that of justice which ensures that all obtain what is due to them[11]. If participants in financial markets act justly then they can trust each other. The importance of trust in financial markets is also illustrated by the fact that the word "credit" is derived from the middle French, Italian and Latin word for trust, again as noted by Cardinal Nichols in his many interventions following the financial crisis.

Another theme that could have been developed further is that of culture. The creation of an ethical culture relies on the education and formation of young people, but is also part of the wider social responsibilities of businesses as discussed in Alves et al (2018). The economy can interact with the broader cultural sphere through professional associations and societies, unions and a variety of other bodies[12]. But culture is important in economic life itself: the economic and cultural sectors are not separate. And the economy is not simply made up of atomised individuals whose decisions do not affect the decisions of others. Culture can have an important impact on how we behave. A degraded culture does not turn wrong actions into right actions, but it may make it harder to do what is good and reduce the culpability of those behaving unethically[13].

The Vatican letter does mention this issue, pointing out: "Every business creates an important network of relations and in its unique way represents a true intermediate social body with a proper culture and practices. Such culture and practices, while determining the internal organization of the enterprise, influence also the social fabric in which it operates." (23) It is, however, an area that could be developed further.

Influencing culture for the better is a responsibility of Christians in all walks of life. An appropriate culture aids the exercise of the virtues[14]. It was mentioned in *Caritas in Veritate* that the relationship between the market and the moral-cultural sphere has not always been as explicit in recent Catholic social teaching as it could have been. But, given that economic action is simply a subset of human action more generally, the cultural aspect and the impact of culture on decision-making cannot be ignored. The education sector can assist with the development of an ethical business culture, not just be teaching about ethics and virtues in general, but by applying the ideas to realistic case studies to better prepare people for business life. This is especially true at university level and in professional development.

Making judgements about the particular – the need for prudence and courage

[11] "What is due to them" does not mean simply what is due to them according to written contracts, it can also relate to verbal agreements and implicit agreements (i.e. what two parties really expect when they enter into contracts).

[12] See Charles (1998, pages 392-394).

[13] Again, see Alves et al (2018).

[14] A particular example of this is given by Schneider and Williams (2013). In his section of the book, Schneider reports econometric results that suggest that the extent of the black economy is influenced to a considerable degree by "tax morale" which includes as one aspect whether people believe that other people are paying the taxes that are due. In a rather different field, Matthew Syed (The Times, 12th November) noted how people who might behave ethically in one area of their lives may not behave ethically in another where the culture in which they are operating is degraded. He was illustrating this using sport as a specific example.

We can also consider those aspects of the Vatican's 2018 letter that dealt with specific issues (approximately paragraph 15 onwards) with a view to bringing to bear other disciplines and the practice of virtue ethics to expand upon and critique the ideas in this latter part of the letter.

There are a number practices brought up in the letter that are not in themselves objectively unethical but which may have undesirable consequences in certain circumstances[15]. This is true in any area of human activity. To give an example from another field, it would always be wrong to drive a car at high speed without consideration for other road users. However, if the conditions are wet and dark, to what extent should we go below the speed limit? Should we drink at all before driving (where legal) and, if so, what should be our limit in different circumstances? How much money should we spend on car safety for our children if other family budgets are affected? Such decisions, *inter alia,* require prudence (for example, there is no point spending money on car safety if it makes an infinitesimal difference to the likelihood of an accident but the children cannot go on holiday) and courage (for example, turning down the second drink at a party when everybody else is drinking).

The letter points out correctly: "What is morally unacceptable is not simply to profit, but rather to avail oneself of an inequality for one's own advantage, in order to create enormous profits that are damaging to others; or to exploit one's dominant position in order to profit by unjustly disadvantaging others, or to make oneself rich through harming and disrupting the collective common good." (17) To act like this offends justice and involves choosing the wrong ends.

Examples of financial market activity given in the Vatican's 2018 letter that require discernment are high frequency trading (though with no elaboration) and financial speculation (17): "Such a practice is particularly deplorable from the moral point of view when the intention of profit by a few through the risk of speculation even in important funds of investment, provokes artificial reduction of the prices of public debt securities, without regard to the negative impact or to the worsening of the economic situation of entire nations. This practice endangers not only the public efforts for rebalancing, but also the very economic stability of millions of families, and at the same time compels government authorities to intervene with substantial amounts of public money, even to the extent of artificially interfering in the proper functioning of political systems."

The practice of speculation has been widely discussed in the development of Catholic social thought. Perhaps the most authoritative reference on speculation and moral theology in mediaeval times is Baldwin (1959) who wrote: "The general prohibitions against speculation on the market were also within the province of the internal forum[16]. The Carolingian capitulary Quicumque later adopted by Gratian attacked those who bought cheap in time of plenty and sold dear in time of dearth with the intention of making an avaricious profit (*propter cupiditatem*). It was the intention that was immoral and not the actual buying and selling, because in terms of the external forum both the low price in times of abundance and the high price in times of scarcity would be the current and hence the just price. In the second half of the twelfth century the decretal *In civitate* of Alexander III renewed the prohibition against such speculation, but stated

[15] "Undesirable" might include destabilising the financial system, consumers taking poorly-informed decisions or a range of other outcomes.

[16] Interestingly, this is a phrase Pope Francis has used in a different context.

plainly that it was unenforceable in a public court of law because intentions are solely a matter between the individual and God."

The sense of this quotation is clearly suggesting that speculation is morally problematic whilst it should not be illegal. However, it does not close down the debate. Nakrosis (2013) examines objections to speculation in moral theology as discussed by Nell-Breuning[17]. Nakrosis' conclusions are interesting, because he notes that speculation can have economically valuable effects and, in those cases, it should not be assumed to be morally wrong. Nell-Breuning himself did not come out firmly against speculation, but he did suggest that proximity to it could tempt people into sin. Johannes Messner's position was not dissimilar from this and the way the Catechism (2409)[18] defines sinful speculation strongly implies that there is such a thing as licit speculation[19].

In fact, the letter does not say that speculation is always and everywhere wrong, though it can be argued that the letter leaves the casual reader with that impression. Speculation can clearly have benefits. For example, in markets such as those for food, it can bring forward production of the physical commodity at times of shortage and can also reduce price fluctuations in markets. Speculation can provide liquidity which is helpful to (for example) farmers who wish to protect themselves against price fluctuations using futures and forward contracts. Speculation can also lead to information being reflected in share prices more rapidly[20].

Of course, there are critiques of speculation too, including within the academic economics literature. For example Nobel Prize winning economist Robert Shiller (2017)[21] who is an expert on the issue himself and, in that publication, describes common-place discussions of speculation in the US in the 1920s and 1930s.

The letter also mentions high interest rates being charged to borrowers (16) and the use of offshore financial centres (30 and 31). In the former case, it is not suggested that interest should not be charged at all, and most modern interpretations of usury would permit the charging of interest on loans. The relative ethical merits of different forms of contract and different levels of interest rate again require discernment. With regard to offshore financial centres, the letter concedes that they can be used to avoid double taxation, but is generally highly critical of them on the ground that the use of offshore financial centres can lead to tax evasion and criminal activity[22].

The phenomenon of debt securitisation also comes under scrutiny (26). This was discussed by, for example, Crowley (in Booth ed, 2010) in an early contribution by Catholic thinkers following the financial crisis. Again, it cannot be said that securitisation is intrinsically morally problematic. If our concern is complexity, there is

[17] Nell-Breuning was the author of *Quadragesimo Anno.*

[18] The Catechism is listed in the references as Catholic Church (1994).

[19] See also Gregg (2016).

[20] It can be argued that if there had been more short-selling of bank shares in the financial crash, banks would have been less able to build up more and more risk as the events of 2007-2008 unfolded.

[21] Interestingly, the Vatican's 2018 letter uses the phrase "irrational exuberance" which is widely believed to have been coined by Shiller.

[22] As it happens, the UK government's estimate of the loss of tax from offshore centres is very low as a result of action that has been taken in the last few years and most offshore centres rank very highly on indices of corruption (that is, they have low levels of corruption). It is also worth noting that the Vatican City State itself is, in effect, a tax haven and used as one.

no logical stopping point where we can say “this is too complex: it should be prohibited” or, indeed, “this is too complex: it is unethical”. Mortgage securitisation, which is often blamed for the financial crisis, was widely welcomed by central bankers and regulators as well as by people in financial markets. Indeed, Paul Tucker, the director in charge of financial stability at the Bank of England speaking just before the crash said: “So it would seem that there is a good deal to welcome in the greater dispersion of risk made possible by modern instruments, markets and institutions” (Tucker, 2007). If the intention of those creating such securities was to lower funding costs for investors and help disperse risk (thus benefiting their own firm, households and all those who relied on the stability of the banking system) then it is difficult to argue that their creation was immoral.

The fact that this range of activities is not intrinsically unethical leads back to the question of how we can know when they are appropriate or not. The issue of their regulation will be discussed below. But, when it comes to the action of individuals operating on their own behalf or on behalf of the companies for which they work, the question of formation in the virtues arises again and perhaps should have been given greater consideration within the Vatican’s letter. Whilst some activities in financial markets may be regarded as intrinsically bad or of no social use, the fact that it is so difficult to draw that line calls for the exercise of the virtues.

In this case, the virtue of prudence[23] is especially important. There may be long chains of cause and effect between chosen means and desired or unintended ends and consequences. Operating with wisdom (paragraph 1 of the Vatican’s 2018 letter) and in a way that is well informed, especially about the impacts on those to whom we owe special duties, is of crucial importance. In addition, the virtues of fortitude and courage are also crucial. The amount of money tied up in the described activities and the difficulties for businesses when changing course away from a particular business plan mean that it can be difficult to act in an appropriate ethical manner either as an individual or in terms of setting the corporate strategy. In this context, “speaking truth to power”, whistle-blowing and even resigning one’s own position can be courageous acts of virtue in the face of temptation. Again, these are virtues that can be nurtured (or destroyed) by culture and developed by continuing professional development and other forms of education.

The Vatican’s letter also mentions the problem of “information asymmetries” (14). This is a technical economic term. In one of its manifestations, it describes a situation in which a seller of a financial product has more information than the buyer and thus *caveat emptor* can be problematic. Once again, virtue ethics is necessary. Faced with a situation of serious difficulties in some markets, human imperfection amongst market actors who might take advantage of others and the inability of regulatory and other external interventions to deal with the problem effectively (see below), the building of an ethical culture, through education and otherwise, is important[24]. In ensuring that the common good is promoted in these complex situations, the virtues of prudence (which help the buyer and seller understand the problem, including, crucially, what they do not know); justice (to ensure that the other party obtains what is due to them); and courage (if one is in a situation where considerable pressure to behave

[23] Prudence is the virtue that disposes practical reason to discern our true good in every circumstance and to choose the right means of achieving it (*Catechism*, 1806).

[24] St. Thomas Aquinas, *Summa Theologica,* II-II, Q 77, Art 2, 3 deal with this question using the practical examples of horses and coinage. There is almost nothing more to be said!

inappropriately is being applied) are all necessary. Again, these virtues need to be nurtured not just in schools, but in university business courses and professional training.

Overall, it is reasonable to say that the Vatican's 2018 letter raised a number of products and activities that are well known to have benefits in some circumstances but which can easily lead to difficulties and perverse outcomes. In this context, a much deeper consideration of virtue ethics applied to these specific situations would have made the analysis more complete.

The Vatican letter and statutory regulation

Given that human imperfection can destroy the effective functioning of financial markets, what should be the political-institutional response? The Vatican letter suggested the following: "At the same time, it is clear that markets, as powerful propellers of the economy, are not capable of governing themselves. In fact, the markets know neither how to make the assumptions that allow their smooth running (social coexistence, honesty, trust, safety and security, laws, and so on) nor how to correct those effects and forces that are harmful to human society (inequality, asymmetries, environmental damage, social insecurity, and fraud)." (13)

This is a slightly odd anthropomorphisation of markets. Markets operate within a human-created institutional structure and involve exchange, very often on an impersonal basis. They are not capable of "knowing" anything. However, individuals involved with market exchange are capable of knowing and controlling their behaviour. As noted in *Caritas in Veritate,* things can go wrong in markets because of human error and sinfulness. But human persons can choose another path too. "Markets" are not capable of choosing any more than a "farm" is capable of choosing whether to use cruel techniques to husband animals. Markets and farms are both abstractions.

So, markets may fail because people may fail. One possible solution to their failure is regulation by the state. *Caritas in Veritate,* for example, stated (21): "regulation is made even more necessary in view of the fact that among the major reasons for the most recent economic crisis was the immoral behavior of agents in the financial world". This message was echoed in the Vatican's 2018 letter (especially 21).

There is a problem, however. The belief in regulation to deal with human imperfection assumes a degree of perfection amongst those taking decisions in relation to regulation that cannot be found either amongst market participants *or* amongst those taking decisions in government regulatory bureaus.

Instead of being developed for the general public interest, regulation can be shaped by private interests. Indeed, Catholic social teaching (including Pope Francis) has warned about this. This is one of the areas of research for which James Buchanan won his Nobel Prize in 1986 and is explored in the discipline of public choice economics.[25] This is an area of economics typically associated with free market economists, but Stiglitz (2010) and Marquand (2014) have also mentioned the problem of private interests shaping regulation coming from a left-leaning perspective.

These private interests might be regulators themselves, politicians or the regulated industries which may try to capture the regulatory process for their own benefit. In addition, politicians and regulators may have cognitive biases that lead them to over-

[25] See Meuller (2003), though Buchanan's Nobel Laureate lecture (Buchanan, 1986) is a more digestible source.

estimate the efficacy of government regulation: they are not neutral arbiters. Furthermore, following a theme of Austrian economics, they will not be able to predict with confidence the impact of their actions and regulation may lead to the opposite of the intended effects.

These are all manifestations of the reality of human imperfection which it is foolish to ignore. To put it simply, one imperfect human institution (government) cannot be expected to perfect another imperfect human institution (the market). It might not even improve it.

One does not have to go far to find interventions by government institutions that demonstrate the problem. In the run-up to the financial crash, the extensive international framework for bank regulation (the Basel Accords) explicitly encouraged securitisation and the development of the complex instruments that many believed were at the seat of the crash. The US financial regulatory system also very much encouraged and gave government guarantees to complex mortgage-backed securities, especially where those securities related to loans taken out by low-income households[26]. US regulators also required banks to discriminate in favour of borrowers who had a low capacity to repay their loans (and such loans were often granted without any proper documentation of ability to repay).

The point here is not to excuse those responsible who worked within banks in the 2000s. The problem is that nearly all actions taken by regulatory authorities or central banks made the financial crash either no less likely or made it more likely and its effects worse. Those who regulated banks were carved out of the same block as the rest of humanity and share the same imperfections as the rest of us and that has to be our anthropological starting point.

It is often suggested that one of the problems of regulation is that it tends to be national whilst the problems that failures within the financial system create are international. This issue was also raised in the Vatican's 2018 letter (21). As it happens, there has been an explosion in international financial regulation in recent years and this started before the financial crisis. The Bank for International Settlements regulates capital requirements for internationally diversified banks. Super-imposed on this is the system of European Union financial regulation. The regulation of accounting standards takes place at the international level. The International Organization of Securities Commissions (IOSC) develops global standards for the regulation of securities markets. And the International Association of Insurance Supervisors are bringing about common standards for the supervision of insurance companies.

It should not be assumed that this makes financial markets more stable or inclines them towards promoting the common good. When financial institutions are regulated on the same basis worldwide, if regulators make mistakes, those mistakes will be experienced and potentially be amplified worldwide. They may encourage similar behaviour and similar business models in a way that is dangerous for the world's financial system. As Yale law academic and NBER scholar Roberta Romano has put it: "Recent experience suggests that regulatory harmonization can increase, rather than decrease, systemic risk. By incentivizing financial institutions worldwide to follow broadly similar business strategies, regulatory error contributed to a global financial crisis […] there are bound to be regulatory mistakes, both large and small. Moreover,

[26] See above comment by Paul Tucker – regulator approval for such instruments was widespread.

an internationally-harmonized regime impedes the acquisition of information concerning the comparative effectiveness of differing regulatory arrangements, lowering the quality of decision making, as nations are discouraged from experimenting with alternative regulatory arrangements."[27]

These sections of the Vatican's letter on regulation reinforce the need for an inter-disciplinary approach to teaching. A combination of different strands of economics and political economy, combined with an understanding of Christian anthropology and the practicalities of the financial system, is important. Also, the limitations of regulation point again to the need for virtue ethics. These points are explained at length in Bishops' Conference of England and Wales (2010) using different language, but are less well developed in the Vatican's 2018 letter.

The principle of subsidiarity in financial regulation

When considering the question of the regulation of economic life, Catholic social teaching has a long history of emphasising the importance of civil society institutions in regulating the economy[28]. This is important given the potential shortcomings of government regulation in dealing with many of the problems that are perceived to exist in financial markets.

Although the recent Vatican letter (quoting an earlier Vatican letter on the financial crisis) suggested that deregulation leads to a regulatory and institutional vacuum (21), it went on to say, in apparent contradiction: "Numerous associations emerging from civil society represent in this sense a reservoir of consciousness, and social responsibility, of which we cannot do without. Today as never before we are all called, as sentinels, to watch over genuine life and to make ourselves catalysts of a new social behavior, shaping our actions to the search for the common good, and establishing it on the sound principles of solidarity and subsidiarity."

The tradition of regulatory institutions developing within financial markets that, it could be argued, was neglected in the Vatican's 2018 letter. There are numerous examples of such institutions regulating financial markets with great effect[29].

The first example is that of stock exchanges. Until 1986 in the UK, and in earlier times in other countries, exchanges were entirely market-generated regulatory bodies which regulated markets strictly. Indeed, the regulation of the London stock exchange was so tight that its powers were curtailed by the government which believed it was acting as a cartel (see Booth, 2014). The London stock exchange, like others, was essentially a club or society which could determine its own rules for membership and for the behaviour of its members.

Stock exchanges are not the only examples of private rule-making institutions in financial markets. Professional bodies blossomed in mid-to-late nineteenth century financial markets: interestingly, their importance is mentioned in Catholic Church teaching in other contexts though they were not mentioned in the letter[30]. For example, in the US from 1875 to 1930 there was very little regulation of accounting. Indeed, publicly quoted firms did not have to be audited, though many were. However, by 1926, 90 per cent of companies quoted on the New York Stock Exchange had audited

[27] Romano (2014).

[28] For example, see *Centesimus Annus* (48) in relation to regulation of human rights in the labour market.

[29] See especially Stringham (2015).

[30] See, for example, *Quadragesimo Anno* and *Centesimus Annus*.

accounts and there were professional bodies of accountants with their own rules who were responsible for auditing in many cases.

Such regulatory institutions are continually developing in new contexts, though they are often subservient to government regulation. Over-the-counter derivatives business is almost wholly the preserve of wholesale investors but, interestingly, those markets do not go unregulated, even though they do not attract the same regulatory interest from governments as consumer-facing markets. These markets are regulated by a private body, the International Swaps and Derivatives Association (ISDA). ISDA's mission is: "[to foster] safe and efficient derivatives markets to facilitate effective risk management for all users of derivative products." It achieves this in a number of ways all of which involve regulatory functions, such as: "Developing standardized documentation globally to promote legal certainty and maximum risk reduction." Members have to apply to join and can have their membership revoked.

Thus, it could be argued that the principle of subsidiarity, and how it might apply to regulation, especially involving market-based and civil society organisations is an under-explored topic in the letter. Such organisations can be effective in dealing with a number of the concerns expressed in the letter about financial markets. They can help ensure that there is not a "regulatory vacuum". Such institutions can especially assist consumers in markets where there is complexity and where information asymmetries lead to problems and undermine the principle of *caveat emptor*. From the point of view of educators, the professions, exchanges and other institutions that provide regulatory order in civil society and markets are important aspects of our economic institutional life that should be discussed in basic courses on economics (as they once were) and in economic history. Furthermore, their benefits and limitations, as compared with other forms of regulation, is a legitimate subject of study in the discipline of political economy.

These institutions are also especially important because of their link with culture. Professional bodies in particular not only provide education in technical aspects for their members but can, and should, provide education on ethical conduct in professional life.

Conclusion

The 2018 Vatican letter *Considerations for an ethical discernment regarding some aspects of the present economic-financial system* contained important reflections on ethical behaviour in economic life with particular emphasis on the financial system. In this respect it reinforced and expanded upon earlier teaching such as that to be found in *Caritas in Veritate.*

Although it may be reasonable for economists to examine technical or empirical questions without considering wider ethical issues, given that economics involves the study of human behaviour, the relationship between economics and ethics cannot be ignored and is an important subject for Catholic Church teaching. In economic life, people have to choose ends and means and such choices require ethical discernment.

Whilst the Vatican's letter made this clear, it did not stress the importance of the virtues which are key to the taking of good decisions in complex and challenging circumstances. The relationship of the practice of the virtues to behaviour in financial markets is a crucial area for future development of Catholic social thought and teaching. As it happens, this was covered in more detail in Bishops' Conference of

England and Wales (2010) and has been a key theme of Cardinal Vincent Nichols since the financial crisis.

The letter also raised questions about complex financial products and was critical of a number of practices within financial markets. It proposed statutory regulation and the internationalisation of regulation as a solution. Again that is consistent with earlier Church teaching. However, consideration of the nature of the human person would lead one to question the extent to which outcomes in markets can be improved by statutory regulation. Various strands of political economy theory and empirical work would confirm such scepticism. The virtue of prudence is important in determining whether and how to regulate. Furthermore, if statutory regulation cannot be assumed to improve outcomes in markets, this once again makes it all the more important that the virtues are practised.

It is also worth noting that a study of the history of financial markets, as well as Catholic social teaching in other fields, may lead us to be pre-disposed towards regulatory institutions that arise within markets (such as exchanges) and also economic and civil society institutions that regulate human behaviour in markets, such as professions. Such organisations can also have an important impact on culture and they clearly align with the principle of subsidiarity.

There are a number of lessons for educators that can be derived from the letter. The virtues should be taught and formed in the home and in schools. They should be further developed in universities and in professional development courses where they should be applied to case studies. There is a need for an inter-disciplinary approach to the study and research of many of these questions. This should include not only finance and economics, but also various aspects of political economy and economic history, as well as virtue ethics grounded in theology and philosophy. The letter mentioned this, especially referring to the role of the university. But these themes could have been made more prominent. It is clear from a reading of the letter, and from knowledge of the workings of financial markets, that the development of these aspects of university education and professional development would make an important contribution to the promotion of the common good.

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