



University of HUDDERSFIELD

University of Huddersfield Repository

Cowton, Christopher J.

Banking ethics

Original Citation

Cowton, Christopher J. (2010) Banking ethics. Working Paper. Financial Ethics and Governance Research Group University of Huddersfield, Huddersfield, UK. (Unpublished)

This version is available at <http://eprints.hud.ac.uk/6933/>

The University Repository is a digital collection of the research output of the University, available on Open Access. Copyright and Moral Rights for the items on this site are retained by the individual author and/or other copyright owners. Users may access full items free of charge; copies of full text items generally can be reproduced, displayed or performed and given to third parties in any format or medium for personal research or study, educational or not-for-profit purposes without prior permission or charge, provided:

- The authors, title and full bibliographic details is credited in any copy;
- A hyperlink and/or URL is included for the original metadata page; and
- The content is not changed in any way.

For more information, including our policy and submission procedure, please contact the Repository Team at: E.mailbox@hud.ac.uk.

<http://eprints.hud.ac.uk/>



University of
HUDDERSFIELD

FEGReG
Financial Ethics and Governance
Research Group

FEGReG Working Paper 10/01

Banking ethics

Christopher J Cowton
University of Huddersfield

Contact information:
c.j.cowton@hud.ac.uk
+44 (0)1484 473063

This is a draft of a chapter to be published as 'Banking' in J. Boatright (Ed.), *Finance Ethics: Critical Issues in Financial Theory and Practice* (Wiley). Once the book has been published (expected June 2010), this FEGReG Working Paper will be withdrawn.

Financial Ethics and Governance Research Group
The Business School
University of Huddersfield
Queensgate
Huddersfield HD1 3DH
United Kingdom

Banking ethics

Introduction

A bank may be broadly defined as a financial institution which is licensed as a taker of deposits and which makes loans and provides other financial services to its customers. The term covers a wide variety of institutions that differ greatly in size and nature – not only historically but also geographically, and within a particular country.

Most countries have a central bank, which usually has macro-economic responsibilities (especially related to monetary policy), acts for the government in other ways (e.g. managing the public debt), regulates banks and other financial institutions, and acts as a lender of last resort to the banking system. Examples include the Federal Reserve Bank in the USA and the Bank of England in the UK. The operations of central banks are a specialized topic in their own right and will not be addressed in this chapter. However, their regulatory role is of some relevance below.

There are various ways of categorizing banks other than central banks. One distinction of particular significance in the USA is between investment banks and commercial banks – a distinction employed by the US Glass-Steagall Act 1933 (a consequence of the Great Depression), which separated their activities. An investment bank supports and advises on corporations' capital market activities, including mergers and acquisitions. A commercial bank is an institution that accepts deposits of money, makes loans using a proportion of those deposits, and offers related products and services, usually of a financial nature. Although this chapter is about banking in general, its focus will be upon commercial banking.

Some definitions of commercial banks, particularly in the USA, emphasize the receipt of deposits from, and lending to, businesses, whereas others include institutions that perform similar transactions with individuals or households – so-called 'retail banks'. For the purposes of this chapter, the broader definition will be used. In any case, in many parts of the world, commercial banks, in the narrow sense, and retail banks do not exist as distinct entities, and the manner in which the discussion in this chapter is framed can be applied to both.

Through their financial intermediation and other activities, commercial banks play a major part in modern economic life. Their problems towards the end of the first decade of the 21st century attest to this. Intimately involved in so much economic activity, a reduced ability to function on their part is like reducing the supply of oxygen to the economic body. And if they fail – as history demonstrates they are prone to do, especially if appropriate regulations and safeguards are not in place – the consequences can be severe, not only for their own shareholders and customers, but also for businesses and households not connected with the failed bank; even for governments and nation states (Iceland is a recent example).

Although simple in its basic form, commercial banking is a complex professional activity, and like many such activities it entails significant technical and ethical issues. The technical issues that revolve around managing the process of financial intermediation are introduced, quite briefly and in general terms, in the next section. Taking as a springboard the simple model of financial intermediation developed in that section, the principal ethical issues involved are then discussed in three subsequent sections, organized according to three terms – integrity, responsibility, and affinity.

Commercial Banks and Financial Intermediation

Commercial banks (hereafter referred to simply as ‘banks’) undertake a variety of activities. Many offer a wide range of financial products and services (for example, financial planning, pensions, mutual funds, insurance) to their customers. From the customer’s point of view, this can make life simpler; from the bank’s commercial perspective, it is a means of improving profitability through cross-selling. Both the products and services themselves, and the approach to selling them, entail ethical issues. However, at the heart of banks is their banking activity, and in order to stay within scope and at an appropriate length, that will be the focus of this chapter. Thus this chapter is about banking rather than the complete range of activities undertaken by banks.

The core of banking is financial intermediation. A bank can be described as a ‘middleman’ or a bridge between those with surplus funds (savers) and those who require credit (borrowers), whether for consumption, working capital or investment purposes. In attracting funds, commercial banks offer a variety of products, including

checking (or current) accounts and savings (or deposit) accounts. Checking accounts rarely offer significant interest, but they have associated benefit and services, and many banks charge for the services attached to such accounts. Savings and similar accounts that offer interest differ from checking account in two significant ways. First, they usually do not have services directly associated with them. Second, those that offer higher interest rates tend to require notice to be given before withdrawals can be made; or, at least, some interest already earned is relinquished if a speedier withdrawal is required.

Similarly, banks lend on a variety of bases and terms, including overdraft facilities associated with checking accounts, and term loans. Traditionally, the granting of credit has depended on the exercise of professional judgment by skilled professionals, but increasingly in recent decades the process has been automated by the use of credit scoring. Nevertheless, judgment is still involved, especially for large and non-routine lending.

Generally speaking, whatever the method by which the interest rate is set, the higher the perceived risk, the higher the interest rate that will be charged – which means that those who are probably least able to pay interest face the greatest interest rate burden. Risk is inherent in lending; the only way to avoid it is not to lend – which is what banks are choosing to do when they turn down a request for credit, at any price. However, risk is not the only issue that impacts whether, and at what rate of interest, a bank is willing to lend. For a given level of risk, the size of the loan also has an impact, with small loans tending to be ‘priced’ higher (i.e. a higher rate of interest charged) than larger loans because of the bank’s fixed costs of arranging and managing a loan. Very small loans, which may be all that a poor person needs or can afford, tend to be uneconomic for mainstream banks. This can push the poor towards using more expensive or unlicensed lenders – so-called ‘loan sharks’ – which adds to their financial difficulties. One response to this has been the development of ‘microfinance’, the most well known example of which is Grameen Bank. Although outside the scope of this chapter (see Chapter 22), microfinance is worth noting as an essentially socially or ethically motivated response to the perceived failure of banks to cater for the needs of the poor. However, some mainstream banks provide assistance for microfinance operations.

In addition to pricing for risk, banks also pursue various means of reducing it, providing safeguards if the borrower defaults on the payment of interest or the repayment of the principal, or is likely to do so. One is the use of third party guarantors, who stand behind the borrower. Another is for the bank to take security or collateral, often in the form of a fixed charge on a specific asset or assets of the borrower. Mortgage loans are a familiar form of this. Where the borrower is a corporation facing bankruptcy, having security or collateral places the bank ahead of general, unsecured creditors.

The process of financial intermediation can be illustrated by means of a simple diagram (see Figure 1). Savers make deposits at the bank. Since not all savers are expected to withdraw all their funds at the same time, the bank is able to lend on a proportion of the funds it has received, while keeping a smaller proportion to be able to pay savers who wish to reduce or withdraw their deposits. The bank makes its margin by charging borrowers, on average, a higher rate of interest than it pays, on average, to savers. This margin is intended to cover not only the bank's operating expenses but also losses incurred when borrowers default and fail to pay some or all of the interest and principal they owe.

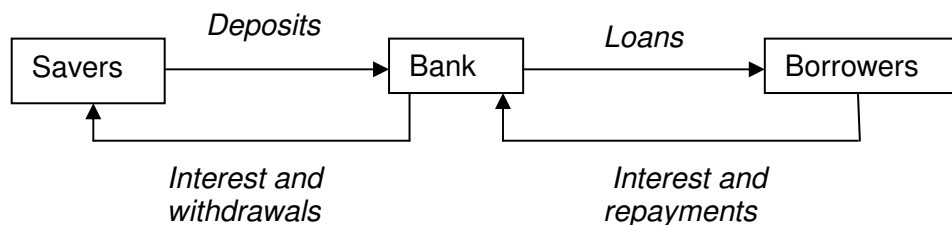


Figure 1. A simple model of financial intermediation

The process underlying this simple model will be familiar to most readers, but it is worth spelling out its essential nature, since it will be drawn on in the remainder of the chapter. As indicated already, the bank can be seen as providing a bridge between saver and borrower. One of the central features of modern capitalism is the way in which much financial capital is freed from ties of family, clan, tribe and even nation. Banks use money received from savers and lend it, generally subject only to financial considerations, to borrowers with whom the savers have no connection. Exploiting

their access to a wide pool of borrowers and using their expertise in assessing and managing lending activities, banks help to ensure that surplus funds are put to financially productive use – subject, of course, to an appropriate level of risk.

However, it is not just a question of acting as a conduit between two parties. A bank can take many small deposits (e.g. from households) and transform them into large loans (e.g. to companies), thus mobilizing savings to contribute to economic growth; this is a major function of banks within an economy. A second transformation is also involved; borrowers usually borrow for much longer periods than depositors are willing to commit their funds for. Again, this is an economically valuable consequence of the bank's financial intermediation, though it also exposes it to significant financial risk.

For the saver/depositor, the financial intermediation engaged in by the bank provides not only expertise in the use of the funds, but also benefits such as liquidity (they have access to their funds without depending on payments by particular borrowers) and diversification of risk (they effectively have a tiny share in a large portfolio of loans). In this sense, the bank acts not only as a bridge but also as a shield; it breaks the direct relationship between savers and specific borrowers. To change the metaphor again, the bank also acts as a veil, since depositors in general have little or no knowledge of the purposes for which their money has been lent or who has borrowed it.

The above paragraph sets out the basic social benefit of banking; the mobilization and transformation of savings to be used in economically productive ways, as reflected in the ability of borrowers to pay interest. However, as the financial crisis of the latter part of the 21st century's first decade has shown, there are significant negative consequences when banks, for whatever reason, fail or encounter severe difficulties in honoring their debts to their depositors. Recent events are just one more episode in a long history of banking crises. Regulators attempt to prevent bank failures by such means as specifying capital adequacy ratios so that banks do not over-extend themselves by lending too much. Yet even an apparently strong bank can be brought down by a 'run' on it, when a large proportion of savers seek to withdraw their funds simultaneously when they lose confidence in the bank's financial stability – a self-fulfilling prophecy, of course. Regulators seek to prevent such panic occurring by various means, and in many regimes smaller deposits are guaranteed by the state. While beneficial to the stability of the banking system, this is counter-productive if

extended to a 100% guarantee of all deposits, because big savers then have no incentive to make intelligent decisions about where to deposit their money, instead simply seeking the highest return, perhaps offered by a less reliable, indeed risky, bank. There is a sense in which judging the soundness of a bank, including the control of moral hazard (see Chapter x), is a task best performed by a combination of regulators and relatively well informed depositors.

Thus, the net contribution of banking to society can, in its broadest sense, be viewed as a balancing act between, on the positive side, productive financial transformations brought about through financial intermediation, and, on the other hand, economic and social disruption if the process goes wrong on a significant scale.

In addition to bringing out the basic nature of banking, Figure 1 also helps to frame the remainder of the chapter as the principal ethical issues relating to banking are explored. The next section examines the ethical issues on the left hand side of the model. In particular, it examines the generation of trust that is necessary for savers to hand over their money to a bank. The section after that considers various possible responsibilities that a bank might have in relation to its lending activities – thus focusing on the right hand side of the model. The final main section then considers how some depositors might have more highly developed and nuanced interests or concerns regarding borrowers or the purposes for which their money is lent, thus ‘reaching across’ the bank ‘bridge’ or ‘seeing through the veil’.

Banking on Integrity

As indicated in the previous section, deposits are needed for the process of financial intermediation to take place. Indeed, historically banking developed from the custodial role of looking after other people’s money. Given the exposure or vulnerability of those who deposit their money at a bank, the most obvious door through which ethics enters banking is trust. In entrusting their funds to a bank, depositors are relying upon both the technical competence of the bank (not to lend recklessly, to collect payments etc.) and the integrity of the bank not to abuse its position – a position not only of holding the money, but also of possessing significant expertise and information not held by depositors. This latter characteristic, information asymmetry, is common to situations of moral hazard where a lay person engages with a technical or professional expert.

Depositors, then, can be harmed both by technical incompetence and by a lack of integrity. A ‘good’ example of the latter within recent memory is the case of BCCI (Bank of Credit and Commerce International), which engaged in fraudulent activity on a large scale. Typical of the former is when a bank is weakened because a large proportion of its loan book is subject to default – though, as noted earlier, it is depositors’ perceptions of likely problems that may be most influential regarding bank failure. However, one of the features of the recent banking crisis is the way in which some of the problems have arisen because of a move away from the traditional model of financial intermediation. First, some lenders, instead of relying upon savers’ deposits, attempted to fund their operations by borrowing on the money markets or by relying on brokered deposits, which often entailed high rates of interest. This saved them trouble and expense in terms of retail operations and was effective – until the money markets became tighter and interest rates rose. Second, some lenders securitized bundles of loans and sold them off to other ‘lenders’, thus disconnecting information gathering and processing in the lending decision from the creation of assets. A combination of the ‘market for lemons’ (Akerlof, 1970) and the ‘winner’s curse’ (Thaler, 1988) (bundles of loans were effectively auctioned off) left many institutions with assets that were worth much less than they had thought, especially when the financial crisis hit.

The difference between technical competence and ethical integrity is largely a matter of intentions (Provis, 2001). Professional bankers are well aware of the importance of integrity for generating trust. ‘Since its earliest beginnings banking has been perceived as a business which depends on mutual trust and personal integrity’ (Lynch 1991: 3). Although personal integrity is an issue, for the depositor, the personal qualities of their contact person (if any) at the bank are not sufficient. When you lend money to a relative or friend, you are trusting a person, whereas when you deposit it at a bank, you are trusting an institution – and the regulators (such as a central bank) that stand behind it. Such a shift in trust from people to institutions is part of the condition of modernity (Giddens, 1990). The institution or system needs to be trustworthy, though that does not mean that the personal qualities of individual bankers are irrelevant. In this context, it is instructive to note the everyday use of the phrase ‘bank on’ to mean to rely upon.

One of the ways in which banks have responded to the challenges of engendering trust on the part of savers is in making more explicit the behavior that might be expected of them, for example through codes of ethics (see Chapter 16; also Cowton and Thompson, 2000). Regulators are also important, seeking to prescribe and proscribe certain behaviors of banks and providing a degree of protection for depositors through their monitoring and deposit guarantee activities. Sometimes ethics and regulation are viewed as substitutes for each other, particularly when regulations are extended to remedy a perceived lack of ethics, perhaps in the context of some scandal; witness calls for more regulation when it is felt that banks have not acted with integrity. However, the relationship between banking ethics (at the level of the individual, the bank, or the industry) and external regulation is more complex than this.

Writing detailed rules for complicated businesses, such as banks, where the pace of change is so great and opportunities for moral hazard abound, is very difficult. Indeed, encouraging a rule-based approach can be ultimately self-defeating, since it can lead to a compliance-focused, ‘hollowed out’ approach to banking, where what is not forbidden is assumed to be permitted. What is more likely to help generate trust on the part of depositors is to treat ethics (or self-regulation) and external regulation as complementary rather than as substitutes for one another. Thus initiative for the development and maintenance of trustworthy behavior on the part of banks is best not left solely to regulators but is to be welcomed when it emanates from the banks themselves, either collectively or individually. Indeed, given uncertainty and fear about banks’ trustworthiness and reliability, developing a good reputation is probably an astute competitive move on the part of an individual bank. Howard Davies, former Chairman of the UK’s Financial Services Authority, considered an ‘ethical, responsible culture’ a ‘win-win’ for financial services firms (Davies, 2001: 284) and in that context it has been interesting, therefore, to see some commercial banks – those that felt able to do so – emphasizing their trustworthiness in promotional campaigns during and following the recent financial crisis. Of course, there is the question of whether such claims themselves are to be trusted, but – without delving too deeply into an argument familiar in the business ethics literature – it is at least the case that the most sustainable basis for developing a reputation for being trustworthy is to behave with integrity, rather than just talk about it.

To summarize, integrity is important in banking, helping to generate the trust that is vital for a banking system to flourish. It is important that depositors trust banks, otherwise there is no money to lend. In the following section I move on to characterize some of the ethical issues that arise in the context of lending that money.

Lending with Responsibility

In acting with integrity and competence towards people who deposit money with them, banks should lend responsibly, in the sense of managing the risk and return characteristics of the loan book so as not to put depositors' savings at undue risk. In this regard, depositors' interests are broadly aligned with those of shareholders. However, banks can be argued to have further obligations, including to stakeholders other than depositors and shareholders.

Responsibilities may change in nature or emphasis over time. Many of those faced by banks are faced by other large commercial enterprises too – for example, to be a good employer, a prompt payer of debts, or a fair competitor (Lucas, 1998). However, some are specific to banks, or are particularly pertinent for them. Before examining some of them in greater depth, it is worth emphasizing that any conception of a company's social responsibility must start with the nature of its business and the social contribution that that business makes. Thus, for example, while corporate philanthropy might be regarded as one component of corporate social responsibility (CSR), it is just one part. On occasions it even seems to be used as a smokescreen, as an attempt to disguise or at least ameliorate the problematic nature of a company's business or the manner in which it pursues that business. Returning to the point made earlier, banks' fundamental contribution to society is bound up with the beneficial effects of the improved use of surplus funds brought about through competent financial intermediation. If they do not succeed in that, they fail in their contribution to society, whatever the other trappings of CSR they might display.

Nevertheless, between the broad issue of the general contribution of banking and the responsibilities that might be attributed to all or many types of business corporation, there remains a set of particular issues related specifically to banking. These are focused on the right hand side of Figure 1 and are concerned with a bank's activities as a lender.

First, particularly given the important role that bank finance plays in many societies, banks can be argued to have a responsibility not to exclude certain groups. This includes a responsibility to lend fairly. The danger is that banks' lending policies, where they are unnecessarily restrictive, will tend adversely to affect certain groups which are denied credit or cannot afford credit on the disadvantageous terms on which it is offered to them. This might prevent those groups from participating in economic life in various desirable ways or drive them to 'loan sharks' and their ilk. Exclusion can happen in various ways, some more deliberate or explicit than others. It might occur, for example, through the so-called 'red lining' of certain geographical areas or the refusal to lend to certain ethnic groups.

Of course, if it is assumed that banks are responsible institutions that seek to maintain their depositors' trust and to earn money for their shareholders, then it might be concluded that any apparent patterns of exclusion exist only because of simple business considerations. However, this can be questioned on several grounds, including that some banks' lending policies – formal or informal – seem to be unjustifiably discriminatory not just in moral (and legal) but also in financial terms. At best, it can be viewed as a kind of laziness not to look more carefully at a particular segment of the market; at worst, it can be viewed as something more perniciously prejudicial.

Second, having lent money, the responsibility of banks can be argued to include not being too hasty to foreclose. Although calling in a loan can be supported in ethical terms as protecting depositors' funds and shareholders' capital, banks should not be over-zealous in seeking to safeguard their position. In other words, they should withdraw lending with some consideration for the consequences for other stakeholders – not just for borrowers, but those indirectly affected too. For example, if a bank calls in a loan from a small firm, it is not only the firm concerned that is affected, but also its network of suppliers and customers, its employees and other business contacts – with both economic and social consequences. The fear is that some banks seek to withdraw too quickly, at the first possible sign of trouble. Since they do not share in any upside in the firm's performance, there is a temptation for downside possibilities to dominate the decision about whether to continue lending.

Third, as Morison (1995) argues, lending too much is potentially as serious a problem, ethically, as lending too little. There is a connection with the previous point here in

that, if too much is lent, then foreclosure is much more likely. Nevertheless, the two are worth distinguishing, for a bank's approach to foreclosure is not necessarily tied to its approach to lending; both may vary according to the degree of profligacy or leniency versus stringency or aggression displayed. Borrowers clearly have a major responsibility in deciding how much to borrow, but so do banks, both in how they encourage borrowing and in how they exercise their expertise in sanctioning loans – bearing in mind that if they are taking security, they might be harmed less than others if things go wrong. In other words, if banks can protect their downside risk reasonably effectively, especially if a relatively high rate of interest is in prospect, they might be more willing to lend to vulnerable borrowers than a proper regard for the interests of those borrowers (and others indirectly affected) would allow.

Finally, beyond issues relating to borrowers, there are questions about the purposes for which loans are made. In particular, in common with other large corporations, banks have been prompted to consider their impact on the natural environment, variously conceived as (for example) sustainability, climate change or carbon footprint. Like other businesses, banks have a direct impact on the environment (e.g. through their use of stationery and occupation of office buildings). However, they do not – for example – clear rain forests or produce hazardous chemicals; their direct impact is limited compared to many businesses. Their indirect impact, though, is substantial (Thompson and Cowton, 2004).

As explained earlier, banks are involved in an incessant search for profitable lending opportunities, and if their industrial borrowers are engaged in activities that significantly and negatively impact upon the environment (especially if the cost is externalized), then the banks are implicated. Given the way in which they transform small, liquid savings into large, long-term loans through financial intermediation, banks make possible industrial activities that would otherwise likely not occur or would occur on a smaller scale. Put another, more positive way, commentators have viewed bank lending as an important lever for limiting or changing business behavior. Thus, for example, the UNEP Statement by Financial Institutions on the Environment & Sustainable Development is a significant element of the work of United Nations Environment Program; about 170 financial institutions were signatories at October 2009 (<http://www.unepfi.org/signatories/statements/fi/>). This is one method of

encouraging banks not to make loans without considering the environmental consequences of their lending.

This section has focused on the right hand side of the model, discussing some of the ways in which a bank might be considered to act more or less ethically, or responsibly, in its lending behavior, going beyond what might be considered necessary to protect the legitimate interests of depositors (and shareholders). It has suggested that there are certain responsibilities in the lending process, which might be seen as prima facie duties (Dancy, 1991). The section has covered both the treatment of those to whom money is – or is not – lent, and the purpose for which it is lent, focusing on environmental impact. Such concerns might be expressed by any observer of the lending process. However, in the next section I wish to turn to the possibility that some depositors, as participants in the process, have a direct, ethically motivated interest in the direction in which their money is loaned or the uses to which it is put. Such depositors have some sense of responsibility for, or affinity with, the use of their deposits. This involves certain deliberate modifications to the conventional financial intermediation process.

Banking with Affinity

The model of financial intermediation presented in Figure 1 separates the saver from the borrower. As explained earlier, the bank sits in the middle of two decoupled processes, with a veil of ignorance – to borrow a well-known philosophical phrase – between depositor and borrower. However, some depositors are uncomfortable with this, and various developments have occurred that offer the potential for concerned savers to deposit their funds with a clear, or clearer, conscience. Such depositors are seeking to make an association, even though there is no direct financial link, between their funds and the loans made by the bank.

I refer to these various initiatives as ‘affinity’ banking. Lynch (1991) calls similar practices ‘viewpoint banking’. I use the term ‘affinity’ for two principal reasons. First, in various fields it stands for relationship by choice, a mutual attraction or resemblance, and hence it seems ideally suited to the coming together of like-minded parties around a values-based or values-influenced financial intermediation process. Second, it is already familiar in a financial context (at least in some countries), referring to credit cards that are associated with a particular organization. The card is

‘branded’ with the affinity organization’s name and logo, and payments are made to it by the card issuer, usually based on initial take-up of the card and usage. Many types of organization, are involved, but amongst the most prominent beneficiaries of these schemes are charities (Cowton and Gunn, 2000; Schlegelmilch and Woodruffe, 1995; Worthington and Horne, 1993).

Some banks have a lending policy that is avowedly ethical or ‘responsible’, going beyond the more general ethical codes and environmental policies already referred to. A good example is that of the Co-operative Bank in the UK. Its Ethical Policy was launched in 1992, capitalizing on the Bank’s historic roots in the co-operative movement. The Policy, which is now incorporated into the Bank’s Partnership Approach, continues to be refined in response to customer opinion and changing circumstances. It sets out whom the Bank will and will not do business with. For example, the Bank states that it will not supply financial services to any organization or regime which oppresses the human spirit, takes away the rights of individuals or manufactures any instrument of torture. Nor will it provide financial services to tobacco product manufacturers. More positively, it will encourage and seek to do business with companies that avoid repeated damage to the environment. The approach is thought to have been a major factor in the Bank’s success in capturing market share since it was introduced (Cowton and Thompson, 1999; Davis and Worthington, 1993; Harvey, 1995; Kitson, 1996; Thompson, 1999), including significant growth in the charities sector (Cowton et al., 2000). Savers attracted to the Bank because of its stance on various issues are expressing a view not only on its trustworthiness as a custodian of funds, but also on the uses to which those funds are put. The Bank’s policy provides an opportunity for some savers’ ethical values to be more closely aligned with the characteristics of the loan book than is the case with most other banks.

The Co-operative Bank can be depicted as ‘a conventional bank with an ethical emphasis’ (Cowton and Thompson, 1999: 10). However, there are other examples of banks or related financial initiatives, many of them of quite recent origin, which seek to go further than the Co-operative Bank in expressing through their product offering a particular set of values or beliefs. The Europe-based Triodos Bank is an instructive example. Triodos has an overarching policy to finance projects ‘which benefit the community, enhance the environment and respect human freedom’. This policy

determines the types of project which the Bank will and will not finance, but Triodos pushes affinity much further than the Co-operative Bank. First, because it is relatively small, it is able to provide more detailed information to its depositors about where money has been lent, thus providing an unusually high level of transparency. Second, within the envelope of its standard social and environmental lending criteria, Triodos gives depositors opportunities to specify more precisely the uses to which they wish their funds to be put, through particular accounts, the money in which is then ring-fenced. Examples of areas of application include organic farming and social housing. Thus Triodos Bank manages to restore a sense of relationship between depositor and borrower which, as explained earlier, tends to be broken in normal banking practice. (For further details see Cowton and Thompson 1999, Chapter 12; Cowton and Thompson 2001.) Another interesting feature is that, although the Bank's policy is to offer relatively attractive rates of interest, in many cases depositors elect to receive a lower rate of interest than the official rate on the account, in some cases waiving it altogether, thereby helping the borrower by permitting funds to be lent on at favorable rates of interest ('interest offset').

Explicit or implicit interest offset is seen in several other affinity initiatives, which might therefore seem to be as much about personal philanthropy as banking or conventional saving. For example, Shared Interest (Cowton and Thompson 1999: Chapter 9; Moore 1993) seeks to lend to Third World producers while providing a very low return to savers. Such schemes, which emphasize social rather than financial return, pose little threat to mainstream banking because, even though they are growing significantly, in terms of total finance they are miniscule. Nevertheless, they are still of relevance to mainstream banks. First, they provide opportunities for collaboration which might help to deflect some criticisms of mainstream banks; for example, they might support, financially or technically, an organization that has a remit to lend to the poor. Second, the initiatives might be regarded as experiments or sources of ideas for schemes which might subsequently be adopted by mainstream banks in some form.

Finally, although there is not enough space within this chapter to do it justice, mention should be made of the growing phenomenon of Islamic banking. In some cases this is practiced by an independent Islamic bank, in other cases by an Islamic banking unit or subsidiary of a conventional bank, with the Islamic component financially ring-

fenced. Islamic banking is widely interpreted to mean a ban on the charging or receipt of interest (Riba), in accordance with Islamic law (Shariah) – though, as in historical debates within Christianity, there is some discussion of whether it is really a matter of not charging *excessive* interest, or usury.

As indicated in Figure 1, the flow of interest payments is central to the financial intermediation process that lies at the heart of conventional, ‘Western’ banking. In Islamic banking, this is replaced by alternative mechanisms, including the payment of fees and the sharing of profits and losses or risks, under various financial contract forms (e.g Mudharabah, Musharakah, Mudaraba) – though some commentators are not convinced that all banking services and products marketed as ‘Islamic’ are really compliant with Shariah. However, it is not only interest that is forbidden (Haram) in Islamic banking. Attention is also paid to the activities that are being undertaken; for example, all dealings in gambling, pornography, alcohol and intoxicants are forbidden, so loans should not be made for those purposes. Overall, Islamic banking involves not only a constrained financial intermediation process, in terms of the direction of lending, but a different type of intermediation process in terms of the nature of the flow of payments between the bank, its depositors and borrowers. Growing rapidly both in predominantly Muslim nations and amongst Muslim communities in other countries, Islamic banking poses an interesting challenge to models of banking focused solely on interest and risk.

Conclusion

This chapter has sought to provide an overview of ethics in banking by focusing on the core process of financial intermediation that banks engage in through accepting deposits from savers and lending to borrowers who seek credit. I have used three terms to frame the discussion of some of the salient issues in banking ethics. First, *integrity* (in addition to technical competence) is important to generate the trust necessary for savers to deposit their funds with banks. A minimum level is necessary for any banking system to flourish and so make its fundamental contribution to the economy and society, with banks using information and expertise to channel funds appropriately to economically productive uses. Second, *responsibility* highlights contemporary banks’ need to take into account the consequences of their lending policies. I highlighted four *prima facie* duties: not to exclude certain classes of customers unfairly; not to foreclose too hastily; not to lend profligately; and not to

lend without consideration of environmental consequences. Third, and finally, *affinity* refers to a set of relatively novel ways in which depositors and borrowers can be brought closer into closer association than they are in conventional Western banking, such that the process or outcomes of financial intermediation explicitly align with the depositors' ethical values.

References

- Akerlof, George A. 1970. "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism." *Quarterly Journal of Economics* 84:3, 488–500.
- Cowton, Christopher J., Julie E. Drake, and Paul Thompson. 2000. "Charities' Bankers: An Analysis of UK Market Shares." *International Journal of Bank Marketing* 18.1, 42-46.
- Cowton, Christopher J., and Christine J. Gunn. 2000. "The Affinity Credit Card as a Fundraising Tool for Charities." *International Journal of Nonprofit and Voluntary Sector Marketing* 5:1, 11-18.
- Cowton, Christopher J., and Paul Thompson. 1999. *Ethical Banking: Progress and Prospects*. London: Financial Times Business.
- Cowton, Christopher J., and Paul Thompson. 2000. "Do Codes Make a Difference? The Case of Bank Lending and the Environment." *Journal of Business Ethics* 24:2, 165-178.
- Cowton, Christopher J., and Paul Thompson. 2001. "Financing the Social Economy: A Case Study of Triodos Bank." *International Journal of Nonprofit and Voluntary Sector Marketing* 6:2, 145-155.
- Dancy, Jonathan. 1991. "An Ethic of Prima Facie Duties." In Peter Singer (Ed.), *A Companion to Ethics*: 219-229. Oxford: Blackwell.
- Davies, Howard. 2001. "Ethics in regulation." *Business Ethics: A European Review* 10:4, 280-287.
- Davis, Peter, and Steve Worthington. 1993. "Cooperative Values: Change and Continuity in Capital Accumulation – The Case of the British Cooperative Bank." *Journal of Business Ethics* 12:11, 849-859.
- Giddens, Anthony. 1990. *The Consequences of Modernity*. Cambridge: Polity.
- Harvey, Brian. 1995. "Ethical Banking: The Case of the Co-operative Bank." *Journal of Business Ethics* 14:12, 1005-1013.
- Kitson, Alan. 1996. "Taking the Pulse: Ethics and the British Cooperative Bank." *Journal of Business Ethics* 15:9, 1021-1031.

- Lucas, John.R. 1998. 'The Responsibilities of a Businessman.' In Christopher Cowton, and Roger Crisp (Eds.), *Business Ethics: Perspectives on the Practice of Theory*: 59-77. Oxford: Oxford University Press.
- Lynch, James J. 1991. *Ethical Banking: Surviving in an Age of Default*. Basingstoke: Macmillan.
- Moore, Geoff. 1993. 'Banking on Concern: Shared Interest Society Ltd and Ethical Investment in the Third World.' In *Good Business: Case Studies in Corporate Social Responsibility*: 64-78. Bristol: Centre for Social Management, School of Advanced Urban Studies.
- Morison, Ian. 1995. "Moral Conflicts in Commercial Banking." In Stephen F. Frowen, and Francis P. McHugh (Eds.), *Financial Decision-Making and Moral Responsibility*: 57-72. Basingstoke: Macmillan.
- Provis, Chris. 2001. 'Why is Trust Important?' *Reason in Practice* 1:2, 31-41.
- Schlegelmilch, Bodo B., and Helen Woodruffe. 1995. "A Comparative Analysis of the Affinity Card Market in the USA and the UK." *International Journal of Bank Marketing* 13:5, 12-23.
- Thaler, Richard H. 1988. "The Winner's Curse." *Journal of Economic Perspectives* 2.1, 191-202
- Thompson, Paul. 1999. "The Future of Commercial Banking – The Internet, Stakeholders and Ethics: A Case Study of the Co-operative Bank." *Journal of Financial Services Marketing* 3:4, 316-333.
- Thompson, Paul, and Christopher J. Cowton. 2004. "Bringing the Environment into Bank Lending: Implications for Environmental Accounting." *British Accounting Review* 36:2, 197-218.
- Worthington, Steve, and Suzanne Horne. 1993. "Charity Affinity Credit Cards – Marketing Synergy for both Card Issuers and Charities." *International Journal of Bank Marketing* 9:3, 301-313.