DEEP insight

# THE FUTURE OF FINANCE

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On the 25th anniversary of the Center for International Finance, this dossier reflects on the big ideas shaping the future.


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Ten years since the crisis, the financial sector needs to reconfigure itself along more ethical lines.

# Here's to the Next Decade

**By Carles Vergara**

Ten years have passed since Lehman Brothers declared bankruptcy on September 15, 2008, contributing to the global financial crisis. Since then, most global economic indicators have recovered: GDP is growing, unemployment rates are down, and many companies are reporting record profits. That said, the effects of the crisis, one of the worst in history, were profound, and we are living with the aftermath: governments and taxpayers still carry the burden of the bailouts; financial returns are low; and public distrust of banks is high.

Five years after the 2008 crisis, in Issue 16 of *IESE Insight* we asked, "What Will It Take to Repair Finance?" Our dossier raised some crucial considerations, which remain just as valid today as they were in 2013. First, clarity, vision and prudence are three principles indispensable for sound business dealings. Second, executives must reconcile the company mission with client needs, cognizant of the effects on wider stakeholders and society. Third, a good leader will make financial decisions with the long-term horizon in mind. Fourth, many of the challenges facing the post-crisis manager are new, so traditional business models must be adapted to today's realities.

The new challenges facing the financial industry were the focus of an event held earlier this year to mark the 25th anniversary of IESE's Center for International Finance (CIF). Two trends stood out: (1) the explosion of fintech and the emergence of new players organized around the client and data, which have modified value chains and increased competition, forcing the financial sector to operate by new rules; and (2) a new social sensitivity to ethics, sustainability, solidarity and inclusion.

For this *IESE Insight* dossier, we decided to explore these trends further. My colleagues in the Financial Management Department at IESE, **MIREIA GINÉ** and **MIGUEL ANTÓN**, look at the forces that are driving the fintech revolution, giving rise to market players that are delivering better, more personalized services faster and with greater efficiency, and thereby stealing market share away from traditional banks.

Another colleague, **CHRISTIAN EUFINGER**, elaborates on this trend but focuses on alternative forms of financing – specifically, crowdfunding. He categorizes the options and compares them with traditional bank financing. For anyone wondering whether crowdfunding might be right for them, Eufinger explains the pros and cons – with one of the biggest pros being the human-centered approach that banks seem to have sacrificed. His article should serve as a wake-up call to banks, which Eufinger feels have been too slow to react to new sources of competition.

When it comes to the need for ethics in banking, **CHRISTOPHER COWTON**, a financial ethics scholar from the University of Huddersfield, also feels the profession has been too slow to act. According to Cowton, commonly agreed-upon ethical standards were glaringly absent when the financial crisis struck, and, 10 years later, they don't appear to be any further along. His article throws down the gauntlet, urging industry professionals to get to work defining the cardinal virtues of a good bank or banker. Apart from self-reflection, the exercise he suggests is useful for recruitment, staff development and culture-setting.

"Ethics is not an imposition," IESE's Antonio Argandoña recently wrote in *The Routledge Companion to Business Ethics*, "but an essential component of profitable and responsible decisions." Good financial professionals, he added, should act with prudence, for the benefit of their clients. At IESE, we have always believed this to be true. It is even more true today and, as this dossier attests, may help to avoid another crisis. □

**Carles Vergara** is an associate professor of Financial Management at IESE, a member of the Center for International Finance (CIF) and a member of the *IESE Insight* Editorial Board.

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THE FINTECH REVOLUTION

# How Big Data, AI and Blockchain Are Changing Finance

**By MIREIA GINÉ and MIGUEL ANTÓN**

In late 2017, the struggling beverage company, Long Island Iced Tea Corp., suddenly changed its name to Long Blockchain Corp. At the time, the mania for all things blockchain – the technology on which bitcoin and other cryptocurrencies are based – was at a peak and bitcoin's value was going through the roof. The mere announcement of a pivot into blockchain saw the unprofitable company's stock rise nearly 300 percent. Although this prompted stern warnings from the U.S. Securities and Exchange Commission about cheap attempts to capitalize on cryptomania, the fact that blockchain would give any business such a bump just goes to show the market appetite for it.

Fintech is disrupting the financial industry, adding a glossary of exotic new terms to our business vernacular. What exactly is the fintech revolution all about? Is it a bubble or will it generate true, lasting value?

While *fintech* is a new term, the existence and use of financial technology is not. Financial technology has been around since at least the mid-1990s, with the banking industry being its largest buyer and user. Incumbents

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The arrival of new market players has benefited not just the end user but also businesses, for whom banks have ceased to be the only access point to the financial system. For SMEs, fintechs offer a variety of solutions.

frequently used the technology as much to create market barriers and maintain their dominance as to provide better financial services.

Since then, things have changed. The mass use and adoption of the internet and smartphones, the emergence of cost-cutting technologies, greater regulatory flexibility and radical demographic shifts have all facilitated the entry of disruptive new players. These are what people refer to when they talk about fintechs today.

The arrival of these new market players has benefited not just the end user but also businesses, for whom banks have ceased to be the only access point to the financial system. For small and medium-sized enterprises (SMEs), fintechs offer a wide variety of solutions – from new forms of affordable financing, to faster, more efficient payment methods, to better customer service.

For the past few years, we have conducted research on this topic and interviewed fintech executives. In this article, we will look at the main drivers of this disruptive new phenomenon and analyze some of the potential benefits for companies of all sizes and sectors.


## EXECUTIVE SUMMARY

**The marriage of finance and technology** has given rise to new players that are transforming the financial industry. Many of these fintech firms deliver more economical, flexible, user-friendly services, disintermediating financial services and capturing a considerable part of traditional banks' market share. The days of banks serving as the only access point to the financial system are over. Instead, new technologies are ushering in new forms of affordable financing; faster, more efficient payment methods; and better customer service. This article shows how pioneering fintech business models can afford greater speed and efficiency, personalization, automation and easier access, while reducing many of the problems that have long plagued traditional financial exchanges.


## The Fintech Ecosystem

Driving the fintech revolution are six key forces that interact within a dynamic ecosystem (see **Exhibit 1**). The first big driving force is consumerization. Technology is no longer the sole preserve of IT specialists. Today's consumers are increasingly well versed in technological tools, skills and language, forcing companies to adopt models that originate in the consumer space. The more that technology becomes democratized and consumerized, the less loyal people feel to traditional financial service providers.

A second force is startups – the fintechs themselves. These are the new, entrepreneurial, innovative market entrants that have taken an age-old industry by storm. They deliver more economical, flexible, user-friendly services, disintermediating financial services and capturing a considerable part of traditional banks' market share. According to a 2017 PwC Global Fintech Report, over 80 percent of incumbents believe their current business is at risk, with nontraditional financial service providers already offering payment solutions, transfer services and insurance to 84 percent, 68 percent and 38 percent of their customers, respectively.

Tech developers are the third force. These are the ones who develop the digital platforms and core technologies – such as artificial intelligence, data analytics and cloud computing – that have made it easier for fintech innovators to enter with alternative solutions.

The next force is platforms. The dominant platforms of Facebook, Amazon, Apple and Google have been able to leverage the data they constantly accumulate on their users to offer ever more powerful services. These leading platforms, with their considerable experience and scale, make fearsome competitors, not just for small fintech startups but, disturbingly, for large, established institutions, particularly banks. In fact, these platforms seem to be

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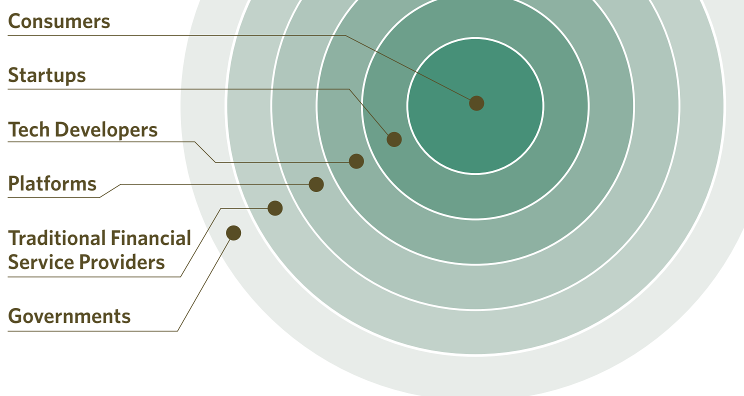


forming their own self-sufficient digital ecosystem that could well supplant that of banks.

Fifth is the traditional financial service providers. Threatened with losing market share, they have been forced to reevaluate their business models in order to find new competitive strategies and attract millennial customers the way that innovators have done.

Monitoring all these constantly changing forces are governments, which try to formulate an appropriate regulatory framework for emerging market players without becoming so bureaucratic as to stifle their initiative.

## New Business Models

A common feature of many fintechs is their ability to generate new business models. As our IESE colleague Javier Zamora has pointed out, the reduced cost of tech allows fintechs to create value propositions with fewer resources than established companies require to launch new solutions onto the market. This democratizing phenomenon has given rise to what's known as unbundling, whereby different financial services are able to be offered by small, separate players, each of which can focus on very specialized propositions. These smaller businesses are integrated within a larger ecosystem, thanks to the coordinating possibilities resulting from greater connectivity among all the players involved in the value proposition.

As such, in each of the different segments of the fintech industry, we find advantageous solutions for companies of all sectors in their daily operations. Let's consider each of these advantages in turn.

### 1 SPEED AND EFFICIENCY

The payments industry is one of the core financial activities that has experienced the most disruption in recent years. Numerous companies have emerged whose solutions can carry out transactions with greater speed and efficiency.

From a consumer perspective, mobile wallets like Google Wallet or Apple Pay are gaining strength, providing a means of making credit or debit card payments using mobile phones. These mobile payment solutions are becoming ever more regularly used for loyalty cards, boarding passes, concert tickets, coupons and a host of other applications.

Likewise, peer-to-peer (P2P) platforms have proliferated, enabling users to transfer money between individuals more easily, more quickly (in some cases instantaneously) and at lower cost (in some cases free of charge). In the United States, the payment platform Venmo moved transactions worth $14 billion dollars in the last reported second quarter of 2018, representing 78 percent year-on-year growth. Some of these P2P platforms are also being incorporated into social media networks.

Fintechs are also simplifying payments for businesses. An interesting example is Stripe, a third-party payment provider for online marketplaces, ranging from large vendors such as Amazon to small businesses that wouldn't otherwise be able to build their own infrastructure to sell their goods online and achieve such global reach.

The company supplies application programming interfaces (APIs) – the communications protocols – for e-commerce sites. These APIs are unique in that they function regardless of the payment method (Stripe partners with all the major card networks), the device involved (whether desktop or mobile) and the country in which the purchase is made (Stripe takes the pain out of foreign currency transactions and the complexities of foreign financial requirements). Because the API can be embedded directly into the e-commerce site

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without redirecting customers to another site for checkout, the online payment experience is seamless from the customer's point of view. The business also benefits, given that most companies that set up their own checkouts often get things wrong or do it in less than intuitive ways. Stripe makes payment from a mobile device as easy as a single click.

The emergence of virtual currencies has also led to an increase in the speed and efficiency of payment systems. With even established giants like Microsoft experimenting with cryptocurrencies, it seems there is growing acceptance for currencies other than fiat money – that is, physical money (paper and coins) backed by governments as legal tender.

The largest and best known cryptocurrency – bitcoin – operates, like many others, via an end-to-end payment system known as blockchain, which facilitates transactions without the need for a centralized authority to certify and validate them. This reduces transaction costs and increases their speed. Moreover, given the way the transaction is time-stamped with immutable information through what is known as a shared or distributed ledger, there's no dispute about payment, and companies are able to exercise better control over returns and reimbursements.

Virtual currencies let funds be transferred directly, safely and economically to any person or company anywhere in the world, which is particularly useful for companies with a strong international presence or with employees located in remote locations. A recent *IESE Insight* article by IESE's Jorge Soley explores the potential benefits of blockchain in general and the Ripple network in particular, whose transaction currency, XRP, has attracted the interest and participation of major global banks.

In this rapidly changing environment, security is paramount. To this end, many fintechs are innovating in the use of biometric data and tokenization – the process of replacing sensitive user data with a nonsensitive equivalent like a series of randomly generated numbers. Yet tokenization has broader applications than just making digital payments more secure. It can be used to represent things other than money, including patient information, property registration or identification of financial assets.

## 2 PERSONALIZATION OF SERVICES

Another benefit of the fintech revolution is the personalization of services, which is already gaining ground in the insurance industry. Several companies innovating to improve the efficiency of the traditional insurance model have given rise to the moniker "insurtech."

Say a customer agrees to install a device that registers their activity when driving. That activity is relayed to the insurer using telematics or the internet of things. Such data could include car speed, brake times, mileage, times of day when the vehicle is used, weather conditions, as well as data related to the customer's general behavior and safety record. The more of this kind of data that insurers have on their customers, the more they can adjust their premiums accordingly. This takes customer segmentation and personalized service offerings to a whole new level.

Artificial intelligence makes it possible to analyze data at a granular level and fine-tune premiums to fit each customer, combatting the problem of homogenization. By being able to set prices in precise, personalized ways, companies can reduce their fixed costs and control the variables. It also positively reinforces desirable behaviors by customers.

The massive growth and availability of real-time data also improves the accuracy of risk assessments for timelier, more customized coverage. We already see this in the area of drone insurance, with Flock insuring drones under a pay-as-you-fly plan.

## ABOUT THE AUTHORS

**Mireia Giné** is an associate professor of Financial Management at IESE. Prior to joining IESE, she worked for more than a decade at the Wharton School as director of Research at Wharton Research Data Services, a global financial reference platform serving more than 450 academic and financial institutions. She currently directs the group's international operations and fintech interests.

**Miguel Antón** is an associate professor of Financial Management at IESE and a research affiliate of the London School of Economics' Financial Markets Group. In 2017 he was selected as one of the Best 40 Under 40 Professors by the B-school website Poets & Quants.

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Smart contracts are another development that seem to be gaining ground. As with other blockchain-based innovations, their strength is that they cut out the traditional middlemen.

An important feature of artificial intelligence is machine learning, whereby systems automatically learn and improve through trial and error without being explicitly programmed to do so. This enables firms not only to identify risks better but to actually anticipate and avoid them altogether. Tyche, an underwriting analysis tool for casualty insurance, does this well. Using machine learning, it crunches open and proprietary data to identify likely claims and then runs it through its own API to generate a claims avoidance model. Its website boasts that it can "concentrate over 30 percent of future claims into less than 1 percent of policies that would otherwise be bound under a carrier's existing underwriting standards, allowing carriers to dramatically improve their bottom lines by declining the riskiest fraction of their books."

Another area where we see personalization is in the trend for micro finance, reaching clients overlooked by big banks. Often these micro products are tailored for low-income people with limited resources or lower valued assets, and are priced proportionately. Microinsurance, for example, puts insurance within reach of vulnerable or marginalized groups in emerging markets, so a poor farmer who has a bad year won't be entirely wiped out and end up in worse poverty.

## 3 AUTOMATION OF PROCESSES

The advent of robo advisers, based on robotic process automation (RPA), affords another key benefit indicated in the name of the technology itself: automation. Policygenius, for example, is an insurance marketplace that has leveraged the affordances of automation to let consumers compare policies, receive quotes and purchase policies directly from the platform without the need of sales agents.

RPA can be incorporated at any stage, allowing firms to automate sales cycles, increase process efficiencies and improve customer service. Many companies are already betting on the technology. When coupled with machine learning, RPA can help companies navigate increasingly complex situations, detecting patterns that analysts fail to see as well as refining or increasing the speed of calculations.

RPA has proliferated in capital management. There are numerous platforms that use algorithms and feed on big data to make considerably cheaper, more accurate financial recommendations. RPA has contributed to the democratization of financial services, particularly helping SMEs invest in assets that they normally wouldn't be able to because they couldn't meet the minimum capital requirements demanded by traditional financial advisers.

RPA can increase the reliability of accounting records by reducing manual errors and automatically collecting data from different registers. Its ability to process natural language and analyze data from social media networks has also helped insurers detect fraud. With RPA, many systems and platforms can be connected simultaneously. Humans could never perform such tasks. For companies, the cost reductions are huge and they are able to redirect their human talent. Freed from repetitive, systematic tasks, employees can expend their energies in areas where their skills are put to better use.

Smart contracts are another development that seem to be gaining ground. Like traditional contracts, smart contracts spell out the terms and conditions of a working relationship but, being computerized, they can be self-executed exactly as they have been programmed, without high transaction costs or ambiguity in the interpretation. As with other blockchain-based innovations, their strength is that they cut out the traditional middlemen. Verification and compliance happen

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EXHIBIT 2

**Benefits of Fintech**

FINTECH BRINGS AN ARRAY OF BENEFITS & APPLICATIONS.

| BENEFITS | ENABLING TECHNOLOGIES | APPLICATIONS |
|---|---|---|
| 1 SPEED AND EFFICIENCY | Blockchain (virtual currencies, tokenization) | ■ Faster, cheaper, more secure way of conducting payments and other financial transactions |
| 2 PERSONALIZATION OF SERVICES | Internet of things<br>Big data | ■ Capture data from customers and generate adaptive and predictive risk models<br>■ Segment customers and personalize offerings |
| 3 AUTOMATION OF PROCESSES | Robotic process automation (RPA)<br>Machine learning<br>Smart contracts | ■ Reduce manual errors<br>■ Collect data from across a range of platforms, devices and sources automatically and efficiently |
| 4 REDUCTION OF TRADITIONAL PROBLEMS | Machine learning<br>Internet of things | ■ Reduce conflicts of interest, fraud, moral hazard and adverse selection |
| 5 EASY ACCESS TO INCREASINGLY SOPHISTICATED TECHNOLOGIES | Cloud computing | ■ Digitalize more firms, especially SMEs<br>■ Generate credit history for those with none |

automatically, making fraud or unauthorized amendment extremely difficult or extremely obvious.

Smart contracts' ability to automatically record movements, measure standards, check quality and track the location of products makes them enormously useful for supply-chain management. Given that these contracts can be programmed as a series of if/then steps, no action will be triggered if your prestated conditions haven't been met.

We see smart contracts being employed across a range of industries, including music and other intellectual property subject to copyright, helping to ensure that authors collect the royalties they are due. In the field of finance, they are used for the clearing and settlement of securities and the payment of coupons and insurance claims, allowing a claim to be activated automatically whenever a specific event, such as a car accident, occurs. The applications are endless, with businesses standing to benefit from greater transparency as well as reduced costs and execution times.

## 4 REDUCTION OF TRADITIONAL PROBLEMS

Conflicts of interest, fraud, moral hazard, adverse selection: stubborn problems that have long plagued the financial industry are effectively being tackled by fintech.

Insurance is a good example. Traditionally, insurers have incentives not to pay out claims while the insured have incentives to claim for as much as they can. This is what is known as moral hazard – the idea that your own behavior is changed when the risks or consequences of your actions are borne by others, or you are protected in some way from your own risky behavior. Emerging fintech business models can address such problems in innovative ways.

One startup, Lemonade, has developed a P2P platform to reduce conflicts of interest in home insurance. The time it takes to process claims is extraordinarily fast. Users simply go to the Lemonade app and submit their claim through a chatbot, which automatically checks the claim against the policy and runs it through various anti-fraud algorithms to decide whether to approve it. Claims can be approved and paid in as few as three seconds.

But it's not just the settlement speed that makes the platform so extraordinary. Lemonade also has a mission to "transform insurance from a necessary evil into a social good." So, of the customer's premium, Lemonade keeps 20 percent and the remaining 80 percent is used for reinsurance and paying out claims; anything not paid out at the end of a year is donated to a charity of the customer's choosing. This "social good" component is one of the things that makes Lemonade so appealing, especially to millennials, and sets the tone for the business relationship. Indeed, the founders drew on insights from the well-known behavioral economist Dan Ariely to embed positive psychology into the

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> The internet of things permits creative possibilities for coming up with more socially responsible alternatives that cut down on the adversarial tendencies inherent in traditional financial exchanges.

technology. For instance, claimants have to take a pledge of honesty and speak into a camera, which disinclines people to lie or commit insurance fraud.

Another company, Friendsurance, uses social ties and group accountability to achieve similar ends. Under its social business model, customers with the same insurance type are put into small groups. If no claims are made by any member of the group, everyone in the group receives some cash back. As claims are paid out, the group's reserves go down, but no one ever pays more than their premium. As the Friendsurance website explains: "Group performance, and its impact on the cashback, promotes responsible claims behavior."

As before, the internet of things permits companies to improve risk profiles and reduce adverse selection – when two parties each have information that the other side needs and they use that private knowledge at the expense of the other. The previous examples show the creative possibilities that exist for coming up with more socially responsible alternatives that cut down on the adversarial tendencies inherent in traditional financial exchanges.

### 5 EASY ACCESS TO INCREASINGLY SOPHISTICATED TECHNOLOGIES

Perhaps the most important benefit of fintech is that a host of new businesses – and SMEs in particular – now have easy access to increasingly sophisticated technologies. Today, more and more businesses can access cloud-based applications to achieve greater integration between systems and enjoy quick, easy, affordable access to big data, thanks to the services of fintech firms. The first fintech wave has helped companies digitalize at remarkable speed and ease, and meet the higher expectations of digital natives.

Likewise, small businesses with no credit history can access new forms of fintech financing. Given that financial institutions cannot properly assess the solvency of companies without records of their credit history, fintech innovations should help SMEs get more and better financing in the future.

## Time to Join the Revolution?

As we can see, the opportunities of the new financial ecosystem (summarized in **Exhibit 2**) are virtually unlimited. For incumbents, not joining the revolution may put them at risk of being displaced from the market entirely. For companies that have been watching events unfold from the sidelines, maybe now is the time to join the fray. □

### TO KNOW MORE

- Miguel Antón and Mireia Giné teach the course "Fintech Revolution: How Big Data, AI and Blockchain Are Changing Finance" as part of IESE's MBA program.
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ALTERNATIVE FINANCING

# Could Crowdfunding Be Right for Your Business?

By CHRISTIAN EUFINGER

"The world's bank is a bottom-up, nimble, person-to-person network that funds and gets money into the hands of entrepreneurs where they need it the most." So said Julie Hanna, executive chair of the board of Kiva, the world's biggest crowdlender, which has given out $1.2 billion in loans since it was founded in 2005. The Kiva website is full of success stories of people who were able to secure the funds they needed to start their own businesses, all thanks to crowdfunding. People like Lindiwe in Zimbabwe, "a mogul in the making," who sells her homemade Lee Juice out of her own shop. And Victor, a Mexican immigrant to the United States, who, despite no credit score or cash flows, finally succeeded in opening the coffee shop for which traditional banks had refused to give him a loan.

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> Traditional lenders are beginning to wonder whether they need to get in on this act before they lose any more clients to these nimbler, more personalized and more efficient loan networks.

Crowd-based funding is among the fastest growing segments in the financial industry. Aspiring entrepreneurs all over the world are discovering that crowdfunding sites offer more than just a fast way to raise finance with no upfront fees and no number-crunching bank managers involved; they also provide great publicity, making it easier to get an idea in front of investors and test their reactions to it.

For banks, this could be a problem in the long run. Some traditional lenders are even beginning to wonder whether they, too, need to get in on this act before they lose any more clients to what they see as nimbler, more personalized and more efficient loan networks that have been quicker to embrace the affordances of technology and smartphone penetration.

This article, based on research and teaching we are doing at IESE in this emerging area, outlines the various options currently on the market, highlighting the strengths and weaknesses of each. Although these funding alternatives are by no means perfect, they have several strengths that traditional banks would do well to bear in mind as they seek to restore consumer confidence and compete with a new breed of tech-driven players.


## EXECUTIVE SUMMARY

**Crowdfunding is among the fastest growing segments** in the financial industry. This article, based on research and teaching at IESE in this emerging area, outlines the various options currently on the market. Although these funding alternatives are by no means perfect, they have several strengths that traditional banks would do well to bear in mind: nimble, personalized, efficient, accountable, transparent, character-based as opposed to purely collateral, credit-based; in other words, *human*. Those are the new guiding principles for a financial industry that needs to restore consumer confidence and compete with a new breed of tech-driven players.


## From Modest Beginnings to a Vast Marketplace

Crowdfunding is the practice of raising funds for a project or business venture by drawing from a large pool of people who each contribute relatively small sums of money, with the transactions mediated via an online platform. Though barely 15 years old, crowdfunding has gone from being on the fringes of the finance universe to radically reconfiguring the way finance is provided, potentially disrupting industries that are centuries old.

A variety of different business models falls under the crowdfunding umbrella, but they all have these features in common: a *project initiator* (or entrepreneur) who needs cash; *contributors* (donors or investors) interested in supporting the project, cause or venture; and a *moderating organization* that provides information about the different initiatives and funding opportunities on offer, and facilitates the engagement between the parties.

There are different categories of crowdfunding, depending on their business models, operating mechanisms and target groups. For the purposes of this article, I will focus on four distinct types as classified by the European Commission's European Crowdfunding Network.

### 1 DONATION-BASED

This form of crowdfunding is most often used for charitable projects. There are no financial returns for funders; instead, funders derive value from knowing they're supporting a good cause – to help pay someone's medical bills, for instance.

Experience with fundraising shows that donors tend to give more to *specific* projects and for longer periods the more they know about the project. As such, crowdfunding platforms tend to feature lots of personal stories, including photos or videos, to help donors feel and maintain closer emotional ties to the cause.

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They also make good use of social media networks, and a significant chunk of funding usually comes from the fundraiser's own family, friends and other personal contacts. Indeed, the prevalence of social media in everyday life is one of the factors that has enabled this kind of crowdfunding to take off, because people like to give directly to those they know and trust, and a prosocial element is built right in.

Examples include GiveForward, FirstGiving and the largest one, GoFundMe, which helps users set up their own fundraising campaign via its platform, share it through social media, and manage the donations they receive. In most countries, the cost of using the platform is free, and if no donations are received, no charge is made. The company makes money by charging around 25 cents per donation, and payment processing fees (of between 1.9 and 7.9 percent, depending on the country) are deducted from each donation.

Given their charitable nature, donation-based platforms may be less relevant for business causes, though some, like Indiegogo, offer a mix of crowdfunding for business interests as well as humanitarian needs.

## 2 REWARD-BASED

For small businesses pursuing creative projects, reward-based crowdfunding is more relevant. The difference here is that, as implied by the name, funders do receive some tangible reward for their investment, albeit in the form of products or services rather than financial returns. It's a middle ground between patronage and commerce.

In addition to Indiegogo mentioned earlier, other well-known examples are RocketHub and Kickstarter. In the case of Kickstarter, the funding model is rather unique in that it has an all-or-nothing funding policy. This means that no one pays or receives anything until the project reaches its full funding goal by a stated deadline. If the total is raised on time, Kickstarter takes 5 percent, plus payment processing fees of between 3 and 5 percent.

What's the attraction? Funders benefit from participating in an interesting project and, if successful, they receive some small perk in return. For example, if they funded the creation of an album, an app, a video game or some gadget like headphones, they'll be the first to receive it – though there's no guarantee that it will be any good. However, most reward-based crowdfunders do it for fun, not for ROI. As the Kickstarter website explains: "It's pledging your support to a creative idea that you want to see exist in the world."

For entrepreneurs, it's a way of trying something out, within a set budget and timeframe, and building up demand and potential orders for a new product or service before actually launching it. It's a good marketing and proof-of-concept tool, and creators don't have to give up any ownership stake to the investors.

Some reward-based crowdfunding platforms allow you to keep any funds raised regardless of whether you meet your goals, and you can go back and ask for more funds even if you miss your deadline. However, this may not be in the best interests of your business, because you may only be throwing good money after bad on a nonstarter.

## 3 LENDING-BASED

This form of crowdfunding is the one that is potentially the most disruptive, because it allows entrepreneurs to bypass traditional financial intermediaries, resulting in cheaper, faster and easier access to money. Instead of borrowing from a single bank, you can receive funding directly from tens or hundreds of individual lenders located anywhere in the world. The difference here is that these are loans, not donations, so there is an expectation of ROI. There are two main models:

**PEER-TO-PEER (P2P).** These platforms act as matchmakers for lenders and borrowers who usually don't know each other, often for the purpose of setting up a business. They can be active or passive. With the former, lenders receive detailed information on the borrower

### ABOUT THE AUTHOR

**Christian Eufinger** is an assistant professor in IESE's Financial Management Department. He teaches banking, corporate finance, valuation and operational finance. He has degrees in business administration and engineering from Darmstadt University as well as a master's in quantitative finance and a PhD in finance from Goethe University, Frankfurt.

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## "Loans That Change Lives"

Socially based crowdlenders like Kiva think they've found a way to fill a gap in the market and change the world in the process.

An estimated 2 billion people in the world are unbanked – meaning they don't have a bank account, and their lack of significant, regular income disqualifies them from ever obtaining loans, credit cards or other traditional banking services. Yet many of these same people are young, entrepreneurial and increasingly connected to the internet via mobile phones. These are ripe conditions for crowdfunders.

One of the biggest growth markets is Africa. Though crowdfunding is still relatively small there compared with the rest of the world, the pace of its uptake has increased considerably over the past three years. According to the World Bank, more than half of the crowdfunding market in Africa is devoted to lending-based platforms, like Kiva, which finances entrepreneurial ventures that are expected to make a real socioeconomic impact, create jobs and help reduce poverty. "Loans that change lives" is its motto.

Crowdlending helped these women in Mali get the working capital they needed to buy goods for resale at their local market.

Koen Verkecht/Kiva

These are microloans given in increments of $25, mostly to support small, community-based, women-led initiatives. Kiva doesn't take a cut of the loan, and lenders don't receive interest from the loans they support. Kiva's operating costs are covered through voluntary donations from foundations and other supporters, so that the borrowers receive 100 percent of the funds. It has a 97 percent repayment rate, which is impressive considering that these are the borrowers that traditional financial institutions have rejected for being too risky.

That said, it's not all plain sailing. The microenterprises funded by these platforms can have high failure rates, leaving an already vulnerable entrepreneur who can't repay a microloan even worse off. Internet penetration and social media use – two keys behind crowdfunding's success – remain low in certain places, and the pace of rollout for these ventures is often dictated by existing mobile network operators and their relationships with central banks. Small businesses must contend with lots of red tape, institutional weaknesses and systemic vulnerabilities, including unmonitored use of big data and raised cybersecurity threats.

So, crowdfunding doesn't solve all the world's problems. But it's a start for those who have few or no alternatives.

SOURCE: IESE professors Inés Alegre and Miguel Ángel Canela have produced empirical studies and working papers on Kiva and crowdfunding in Africa, while Antonino Vaccaro of IESE's Center for Business in Society has produced a series of case studies and teaching notes on Kiva. For more information, go to IESE Publishing at www.iesep.com.

so they can pick which one they want to invest in. With the latter, lenders indicate the risk level they are willing to assume, and the broker matches them to a particular set of loan applications in line with that criterion.

For borrowers, P2P lending has a number of benefits. In most cases, the interest rate is lower than that of banks, as is the collateral needed to obtain the loan. For lenders, the returns are relatively high, but the rewards can go far beyond the purely financial, as in the case of a socially based crowdlender like Kiva (see sidebar).

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> An innovation in the field of crowdfunding is an Initial Coin Offering (ICO). Investors purchase shares in the form of a virtual currency like Bitcoin or Ethereum, which they store in a digital wallet and trade online.

Another upside is that only the lenders' money is put at risk, making it less systemically risky than traditional banking. Unlike banks, P2P operators don't invest any of their own capital in the loans arranged via their platform. Instead, their main source of revenue is the transaction fees they charge from matching loans. Hence, they're not exposed to the credit risk, despite being responsible for the credit assessment of borrowers.

This has a significant downside, though: moral hazard. By not being directly invested in the projects and ventures they host, P2P operators have an incentive to maximize the number of loans they arrange as well as the loan amounts involved, in order to maximize their fee revenue. Consequently, due diligence may suffer, leading to higher default rates. That being said, there's no consensus regarding the extent to which this moral hazard affects delinquency rates. And it doesn't appear to be putting investors off. The market for P2P lending, especially in the United States, continues to grow at speed.

One solution to the moral hazard problem would be to adopt a hybrid model that combines P2P lending with insurance. Ripio Credit Network, for example, allows lenders to assign part of their credit risk to the operator for a fee. The operator estimates the average loss of similar loan portfolios and uses the fees collected from all the lenders to compensate them in the event of a default. By sharing the risk with lenders, the operator has a greater incentive to properly evaluate the credit risks involved as well as to pursue delinquent debtors. In this way, the network reduces the potential for losses while improving conditions for all parties.

**PEER-TO-BUSINESS (P2B).** While P2P lending enables people to lend their money to other individuals (often in the form of consumer loans or loans for smaller, private property transactions), P2B lending enables people to lend to established businesses. Sometimes P2B lending includes government funds as co-investment. For example, in 2014 the British government injected £20 million into small businesses via these platforms. Despite having the same moral hazard problem, P2B lending appeals to lenders looking to invest in corporations but at higher interest rates than those offered by traditional banks.

### 4 EQUITY-BASED

As the name suggests, equity-based crowdfunding enables investors to acquire equity in a company. As such, it has much greater potential upside than debt-based crowdlending. Funders might be especially interested in investing in ventures that reflect their own values, or they might seek to contribute both expertise and funds toward the success of a venture that has piqued their interest. This practice is not dissimilar to what business angels and venture capitalists do.

Examples include AngelList, EarlyShares and Crowdcube. A common misperception is that crowd equity is only applicable to small businesses and startups. While it's true that crowd equity provides funding opportunities that small businesses wouldn't be eligible for through traditional means, it also constitutes an opportunity for more established, mature companies to broaden their choice of funding sources. A recent *IESE Insight* article examined the pros and cons of crowd equity for a business (see sidebar).

## Emerging Models

An interesting innovation in the field of crowdfunding is an Initial Coin Offering (ICO), giving immediate, flexible access to deeper, more liquid secondary markets. Similar to an Initial Public Offering (IPO), investors purchase shares of a company in the form of a virtual currency like Bitcoin or Ethereum,

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## Crowd Equity: Another Lifeline for Startups

For cash-strapped startups, might this be a way to go?

Angels, accelerators, incubators, VCs: there are various options for startups to secure funding. Add one more: crowd equity platforms, which aggregate funds from many individual investors who each take a small stake in the business. For cash-strapped startups, might this be a way to go?

Maybe, maybe not, according to experts who weighed in on the matter in a recent *IESE Insight* case forum.

On the one hand, crowd equity can give startups another lifeline, while smaller investors can access business opportunities normally reserved for deep-pocketed VCs.

However, the democratization of startup funding cuts both ways. For startups, spreading ownership stakes among many individual investors means giving up less control; but investors may not appreciate tying up their money in something over which they have little say.

Making a crowdfunding pitch requires extra time and effort, and publicizing your business plans may be giving too much away at an early stage of growth. It may not be worth it for the generally smaller sums that crowd equity generates, especially if huge cash injections are needed to keep the business afloat.

Money aside, business angels provide professional guidance and contacts to help take you to the next level; they hold your hand through the funding process in ways that the crowd generally won't.

As it exists now, crowd equity may work better as a complement to, rather than a substitute for, traditional sources of equity investment. Still, entrepreneurs are pioneers, so crowd equity's unconventional nature may be just what they need to retain the most independence while road-testing their business idea with the crowd.

SOURCE:

- Klueter, T.M. and A. de San José Riestra. "Riding the Wave: Financing Ventures Through Crowd Equity." IESE Case Study E-187-E.
- See "Wave: Is the Time Right for Crowd Equity?" *IESE Insight Review* Issue 35, Fourth Quarter 2017.

which they store in a digital wallet and can easily trade online.

Such crypto tokens may enable an investor to acquire a product or access a service being offered by a particular venture under development (*utility tokens*, e.g., Filecoin); or they may function as equity shares in a company, paying out dividends and in some cases granting voting rights (*equity tokens*, e.g., Digix); or they can act as short-term loans, charging interest on the principal amount lent to the firm (*debt tokens*, e.g., Steem).

Last year, an estimated $5.6 billion poured into the ICO market. But not all ICOs achieve their funding goals. Of the 913 ICOs identified in 2017, only 48 percent were successful, according to *Business Insider*.

Still, their potential is immense. Thanks to blockchain technology, by which every single transaction is instantaneously tracked and recorded end-to-end without the need for a third-party validator, ICOs could conceivably reconstruct the financial system of shares and securities, decentralizing not just money but stock creation and trade.

The danger with ICOs is that crypto-crazy investors may be more drawn to the coins – in the hope that their value will go up if the venture proves successful – than to the venture itself. To reduce this risk, Ethereum, for example, uses smart contracts, which essentially lock the funds, so people stay vested and don't just trade their tokens, sell up, cash out or quit the venture straightaway. It also helps if a reputable VC firm backs the ICO, which adds legitimacy.

Another interesting example is HiP Property, which uses blockchain technology in the real-estate sector to trade debt and equity in real time. When property owners need access to liquidity, they can simply sell a portion of their equity via the platform. HiP launched in 2016 in the United Kingdom, where an estimated £4.8 trillion of wealth is locked up in the property market, but it plans to expand globally. Its current focus is investment in commercial real estate, but it envisions helping first-time buyers get on the property ladder. Again, crypto has the potential to shake up another established industry – real estate – which the HiP founders describe as "broken, antiquated and geared exclusively in favor of financial institutions."

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**EXHIBIT 1**

## Strengths & Weaknesses

TRADITIONAL BANKING AND CROWDFUNDING BOTH HAVE PROS AND CONS.

| | TRADITIONAL BANK | | CROWDFUNDING | |
|---|---|---|---|---|
| **FEATURES** | **PRO** | **CON** | **PRO** | **CON** |
| extra liquidity in market | | ✓ | ✓ | |
| trust | | ✓ | ✓ | |
| advanced technology | | ✓ | ✓ | |
| personalized services | | ✓ | ✓ | |
| regulated | ✓ | | | ✓ |
| established legal status | ✓ | | | ✓ |
| security | ✓ | | | ✓ |
| privacy protections | ✓ | | | ✓ |
| niche market | | ✓ | ✓ | |
| strong distribution networks | ✓ | | | ✓ |
| independent from existing network operators | | ✓ | ✓ | |
| emerging market contexts | | ✓ | ✓ | |
| helps unbanked poor | | ✓ | ✓ | |
| entrepreneurial | | ✓ | ✓ | |

## An Uncertain Future

As we can see, crowdfunding has the potential to transform the way finance functions, creating new funding opportunities for entrepreneurs as well as everyday people. Yet, being a nascent industry, its future is uncertain. The track record of crowdfunding campaigns is patchy. And because they are not regulated to the same degree as traditional financial institutions, they are susceptible to fraud and not delivering on the promise. **Exhibit 1** highlights some strengths and weaknesses of each.

Lawmakers are struggling to catch up with the pace of technological change and its rapidly unfolding applications. Many crowdfunding initiatives continue to operate in legal limbo. This constitutes a major source of risk for both the platforms and their users.

Given the large volumes of money being moved through the ICO market, some legislators have opted to focus their energies there, drafting new laws for these gray-zone transactions. However, there's no global consensus: the United States regulates them like any sale of shares and securities, whereas China and South Korea have outright banned them. Eventually, there will have to be some agreed regulatory framework. And when that happens, the costs and effort of compliance could reduce some of the advantages of these new funding platforms relative to traditional financing.

Already a shakeout of the peer-to-peer lending industry appears to be underway in China. Under the headline, "China's Peer-to-Peer Lenders Are Falling Like Dominoes as Panic Spreads," Bloomberg reported that, "The government introduced a complex registration process to clean up the sector," and an asset manager was quoted as saying that, "When regulations come in, a lot of P2Ps won't survive." At least 118 Chinese platforms failed in July 2018 alone.

Another important challenge is to develop the means, both legal and technological, to guarantee the security and privacy of investors. Currently, trust is one of the big advantages crowdfunders have over traditional financial institutions, which are still struggling to shake off the reputational damage they suffered as a result of the global financial crisis. It's unclear how long crowdfunders will be able to hold onto this advantage if they don't find ways to overcome their own specific shortcomings and challenges.

The major threat for the banking sector in the short/medium term is the large amount of liquidity that could enter, and in some cases already has entered, the lending market through these new tech players.

In addition, these firms have already developed powerful platforms with far more

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> Traditional financial institutions will need to team up with fintechs. Banks need to get more innovative with their capital and liquidity, perhaps creating their own fintech labs separate from their main operations.

personalized services, due to their access to big data. As we have seen with Amazon and traditional retailers, these platforms are extremely hard to compete with, to the point of rendering the old players obsolete.

Speaking of Amazon, the expertise that it has acquired through online retail gives it a huge advantage over a traditional bank trying to develop a technological solution from scratch. Where banks have tried to adopt more technology, it tends to be in improving their online banking services for existing customers. When it comes to financial services innovation, very few have tried to do it themselves. They have tended to outsource it or buy it in.

For example, instead of trying to go it alone, Bank of America Merrill Lynch has partnered with Amazon, leveraging the big data Amazon has accumulated on millions of sellers to expand lending options for small businesses. We should expect to see more lenders and banks moving in this direction. After all, that's how fintech startups work: they focus on unbundling the services that used to be provided by banks and other traditional financial institutions, with the aim of offering one or two concrete products or services, and doing it extremely well. Now, it wouldn't make sense for Bank of America Merrill Lynch to try to out-Amazon Amazon.

In the medium/long term, traditional financial institutions will need to team up with fintechs not just to stay competitive but to avoid their total demise. In most cases, collaboration, or taking an equity stake, is better than acquiring a fintech, which often results in integration difficulties and the zero-sum game of the acquisition's offerings cannibalizing their own. The main thing is for banks to get more innovative with their capital and liquidity, perhaps even creating their own fintech innovation labs separate from their main operations.

This new wave of technological disruption and disintermediation affords significant wealth-creating opportunities – for entrepreneurs, investors and lenders new and old. As with any game-changing technology or heavily touted new business idea, one must be cautious, discerning and not get too carried away by the hype. At the same time, one must not minimize the extent of the disruption, either. The threat to banks is real, but because they are still profitable, widely used and cash-rich, it doesn't feel imminent. Banks have started to react to these new sources of competition, but suboptimally, in my opinion.

Going back to Julie Hanna, it's worth recalling what she told a WIRED Money conference about crowdlending: "It's patient. It's accountable. It's transparent. It's character-based as opposed to collateral, credit-based. In essence, it's rehumanizing banking. It's allowing us to bring business to all of humanity, and humanity into the way that we do business." Whatever you choose to do next for your business, those are the new guiding principles. ☐

## TO KNOW MORE

- Eisert, T. and C. Eufinger. "Interbank Networks and Backdoor Bailouts: Benefiting From Other Banks' Government Guarantees." Forthcoming in *Management Science*. See "Backdoor Bailouts: Banks Exploiting Other Banks' Government Guarantees" at ieseinsight.com.

- **The European Commission on Crowdfunding** helps investors and businesses seize the potential of crowdfunding, and makes it easier for platforms to offer their services EU-wide. https://ec.europa.eu/info/business-economy-euro/growth-and-investment/financing-investment/crowdfunding_en

- **The European Crowdfunding Network** provides resources and professional support for crowdfunding at https://eurocrowd.org/

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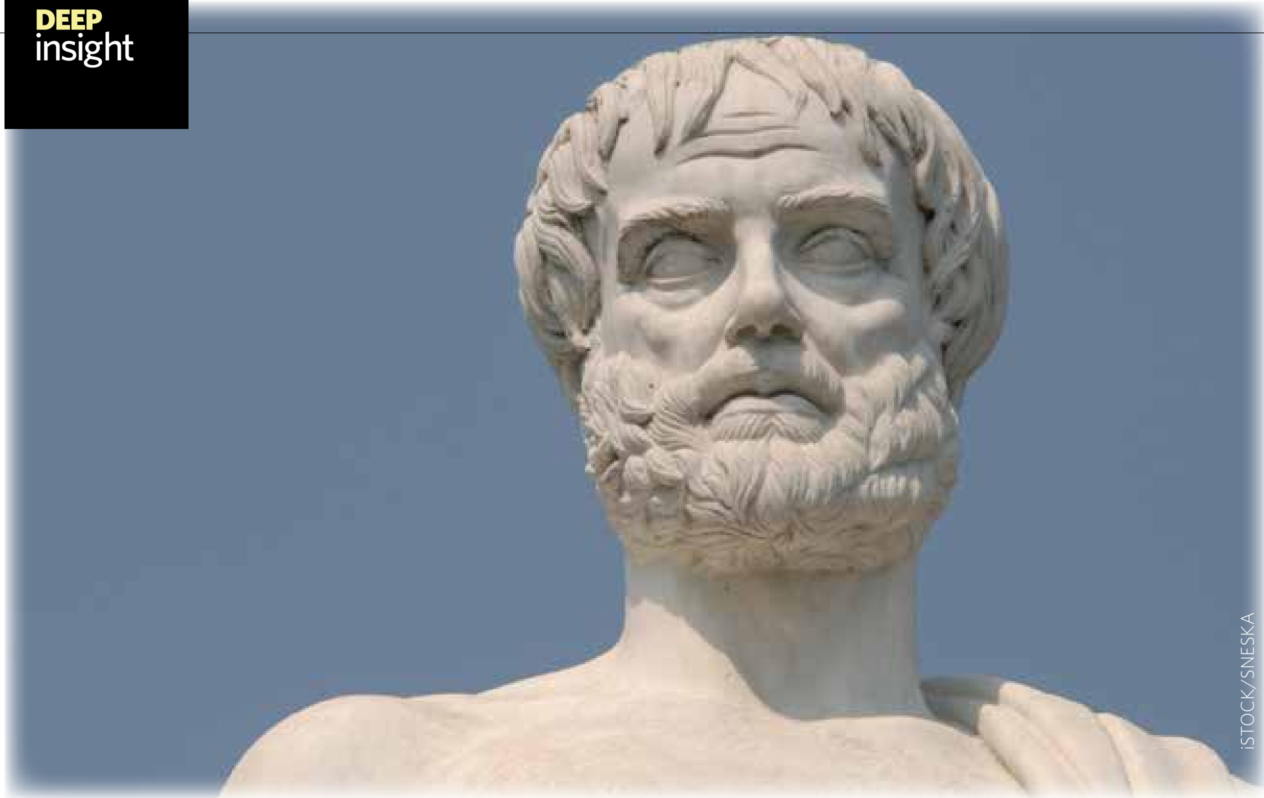
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## A FRAMEWORK TO AVOID MORAL BANKRUPTCY

# In Search of the Virtuous Banker

**By CHRISTOPHER COWTON**

On September 15, 2008, the investment giant Lehman Brothers filed for bankruptcy, the largest in U.S. history. Panic erupted on Wall Street, 25,000 Lehman employees were sent packing, and central banks mobilized to prevent contagion and to keep markets from plummeting.

Lehman's collapse – considered a watershed moment in the history of banking – accelerated the subprime mortgage crisis and profoundly eroded trust and confidence in the global financial system. While not the first banking crisis in history (and probably not the last), its scale and geographic scope had a shocking ripple effect throughout the system, inflicting serious economic and social pain.

At the same time, the crisis provoked a tsunami of commentary and criticism, including accusations of an apparent lack of ethics in the financial system and its principal institutions. Unfortunately, at that moment, there was no substantial body of academic knowledge on financial ethics that the global banking sector could turn to for guidance. And despite some encouraging signs over the past 10 years, the situation hasn't changed significantly.

In this article, I offer some ideas to advance the thinking on financial ethics in a way that I hope makes sense to banks and bankers. I begin with a brief overview of the standard measures used to improve the financial system and their potential shortcomings, as a prelude to showing how financial ethics, particularly in the form of virtue ethics, might fit in.

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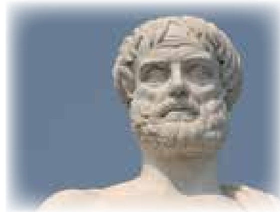



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## Formal Controls & Their Shortcomings

Regulations, corporate governance reforms and codes of practice were among the first solutions set forth when financial turmoil struck. While these formal controls are important, each has inherent limitations.

**REGULATIONS.** In the case of regulatory reform, changes to the incentives and constraints that govern financial institutions often look better on paper than in practice. Formulating detailed rules for complex businesses in dynamic markets is a difficult undertaking that often leads to bureaucratic burden and a climate of box-ticking, game-playing and loophole-spotting. In this context, the spirit and substance of the reforms in question are frequently undermined by following the rules to the letter.

Moreover, regulations encourage us to think in terms of policies and rulebooks. But, as any good leader knows, relying on a rule-based system is not a good way of managing. If you don't get people on your side and if the corporate culture works against the rules, people will always find ways around and between them. The regulator's problem is that its resources – financial and intellectual – are miniscule when compared with those of banks.


### EXECUTIVE SUMMARY

**Despite some progress over the past 10 years,** the controls put in place to prevent another global financial crisis fail to address two key concerns: corporate culture and individual character. There's still a lot of work to be done to define and agree what makes a good bank as well as a good banker. The author, an internationally recognized scholar in business and financial ethics, believes a return to the ancient moral philosophy of virtue ethics is a good place to start. Using an exercise he devised for accountants, he suggests how those in the banking profession might likewise begin to rethink their assumptions, values and stakeholder relationships to come up with a more compelling sense of purpose than the profit-at-all-cost one that precipitated the Great Recession. The virtue framework he proposes can be beneficial for self-reflection, for recruitment and selection criteria, or for framing a staff development agenda. Don't let the lack of an internationally agreed code of ethics for banking stop you from becoming a virtuous banker.


**CORPORATE GOVERNANCE REFORMS.** The financial crisis also prompted a reexamination of corporate governance. This is perfectly natural if, to echo Bob Tricker's insightful distinction, corporate governance is about seeing that a company is run properly, rather than actually running it, which is management's job. Without a doubt, the renewal of corporate boards and the ongoing assessment of directors' responsibilities and activities are critical. Yet corporate governance is hard to get right, especially if incentives and expertise are not well aligned with needs.

**CODES OF PRACTICE.** Company and industry codes of practice provide a means of setting expected standards of behavior. The efficacy of codes, however, depends not only on their content but on their implementation and ongoing cultivation at all levels of the organization, as Simon Webley and Andrea Werner noted in their 2008 article, "Corporate Codes of Ethics: Necessary but Not Sufficient." In other words, it's not enough simply to devise a code of ethical conduct and just leave it to do its work.

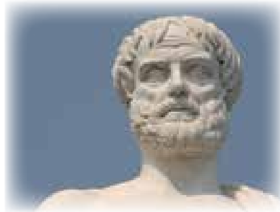
These formal approaches can make important contributions, but on their own they all underestimate the impact of culture, which, even if it doesn't always make or break formal controls, interacts crucially with them. What's needed is an overall control package that merges both formal components – which are relatively easy to change by administrative decree – with informal or social elements.

A truly ethical approach goes beyond mere rules. It not only fills in the gaps in formal systems but gives them life by instilling the spirit of rules and regulations in the corporate culture and in an individual's character. Embedded in culture and character, ethics can help avoid another financial downturn like the Great Recession of 2008, or at least reduce the frequency and magnitude of future crises.

So, what does, or might, ethics in finance look like? Before we get to that, we need to address another question first: is there really room for ethics in banks and banking?

## Finding Space for Ethics

In global banking circles, particularly in Anglo-Saxon economies, the predominant discourse in recent decades has focused increasingly on





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> Some might say, "But we can't afford to be ethical." The evidence suggests otherwise. Being more ethical is not necessarily a bad business move and, on balance, might even be a good one.

shareholder primacy and shareholder value. When this becomes the overriding rhetoric, banks are framed as mere money-making machines, with little room for deliberations on ethics. Against this backdrop, what kinds of discussions are held at corporate board meetings? What issues shape their agendas and set the tone across the organization?

In the years preceding the financial crisis, this overly commercialized bent led many to consider ethics in banking a contradiction in terms, a view surely exacerbated by accounts of individual immoral behavior and the unethical selling of financial products by many banks.

At first glance, the opinions of two great economists, often pitted against each other, would seem to validate this view. After all, banks stand at the heart of the capitalist system, described by John Maynard Keynes in 1926 in these terms: "I think that capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable."

Several decades later, Milton Friedman famously had this to say: "There is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

In this context, one could conclude that shareholder primacy and market competition force out any consideration of nice-to-haves like ethics and corporate social responsibility, and leave much that is "extremely objectionable," to quote Keynes. Nonetheless, Friedman himself recognized that morally desirable actions were not always a drain on profitability but, in fact, might be positively aligned with it. He had no problem with this.

Some might say, "But we can't afford to be ethical." The evidence suggests otherwise. In a 2003 review of 127 broadly comparable studies, Joshua D. Margolis and James P. Walsh suggested a broadly positive link between ethical behavior and corporate performance. In "Corporate Social and Financial Performance: A Meta-analysis," Marc Orlitsky et al. reached a similar conclusion. Granted, these reviews were only picking up tendencies, but what they do affirm is that being more ethical is not necessarily a bad business move and, on balance, might even be a good one.

In short, the evidence indicates that the good guys don't always finish last or even near to last. They might even finish first or thereabouts. There is space for ethics in a competitive environment, even if it's a constrained space. This fits with our everyday experience: who do we prefer to do business with, someone who's decent and trustworthy or someone who's not?

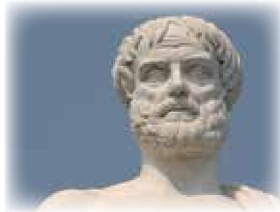
The question now becomes: *how* might an ethical approach be developed in banking?

## Developing an Ethical Approach

Who should take the lead in developing an ethical approach for the global banking industry? Academia can help, but it's likely to be a supporting role.

As John Boatright observes in *Finance Ethics*, finance scholars are constrained by a research paradigm that excludes normative – ethical – questions, and demands the use of particular methodologies and analytical tools. Consequently, finance scholars inhabit a realm with internal conceptual consistency but limited substantive engagement with the complexity of the outside world. Ethical issues, perhaps considered too touchy-feely, cannot be adequately explored in such a space.

The field of business ethics, meanwhile, has grown significantly in recent decades. Yet business ethicists have focused on other issues and published relatively little on finance-related topics. Perhaps they feel that finance, as a set of





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> Financial experts don't dwell in the space of ethics, and ethicists eschew the domain of finance, leaving the intersection of banking and ethics a largely barren landscape. This is still the case today.

practices or as a body of theory, is overly technical or demanding, even if they now realize how important it is. Where they have examined financial topics, they (myself included) have tended to focus more on the margin rather than the mainstream by highlighting topics like socially responsible investment, microfinance, green banks and Islamic banking, as opposed to conventional banking operations. Marginal banking innovations are important, but the scale of their operations is a drop in the ocean compared with mainstream banking.

In short, financial experts don't dwell in the space of ethics, and ethicists eschew the domain of finance, leaving the intersection of banking and ethics a largely barren landscape. As a result, the academic community was not standing ready with advice and insights when the global financial crisis struck.

This is still the case today. There's more interest and activity than there was before, but it's a cottage industry. The banking sector will have to make much of the running itself. But at least this means any solutions are likely to be grounded in the realities of banking practice.

## Creating a More Compelling Purpose

Not long after the global financial crisis struck, I was part of a meeting of regulators, senior banking figures and academics convened to discuss what had happened and how to respond. At one point I asked those present, "What is the purpose of banking?" Not surprisingly, they didn't refer to the creation of shareholder value (much of which had recently disappeared anyway). After a little thought, they came up with "financial intermediation," in particular taking small, short-term deposits to create larger, longer term loans for those parts of the economy that can use the savings productively. So far, so good: a sound, traditional view.

Tellingly, my fellow participants confessed that they failed to see the point of some of the sophisticated financial innovations that had helped get the banks into so much trouble.

Since then, it has been interesting to see how individual banks have tried to create a more compelling sense of purpose. Done well, such narratives can be used to set the tone for the bank's ethos and guide its policies and practices. As an example, Lloyds Banking Group lists three principles in its purpose and vision statement: putting customers first; keeping it simple; and making a difference together.

It's easy to be skeptical about such statements, but they can be a useful way of turning attention to important matters. How can we add some flesh to such bare bones, though?

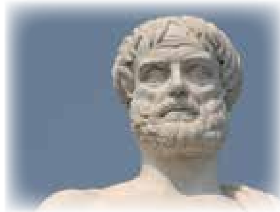
One way hinted at by Lloyds' reference to customers is to think about stakeholders and how a bank should treat them. In business schools, we usually advise students to develop specific lists of stakeholders for each particular organization. In the case of a typical bank, the list might look something like this:

**CUSTOMERS.** Going back to Lloyds' tenet of putting customers first, I would start with separating customers into different groups, since customers come in different forms. How do you treat depositors? How do you treat borrowers? And how do you treat purchasers of other financial products or services?

- **Depositors.** In the case of depositors, bankers have to gain and retain their trust,

### ABOUT THE AUTHOR

**Christopher Cowton** is an internationally recognized scholar in business and financial ethics. The author of more than 60 journal articles and numerous book chapters, he served as the editor of *Business Ethics: A European Review* for a decade and is currently a trustee of the London-based Institute of Business Ethics. He is Professor of Financial Ethics at the University of Huddersfield in the U.K., where he was Professor of Accounting (1996-2016) and Dean of the Business School (2008-2016).



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A bank might ask: what do we do that makes us worthy of trust and what do we do that undermines it? In particular, are our behavior and communications well aligned?

so *trustworthiness* is important to think about. As BNY Mellon Chairman Michael Cole-Fontayn observed in 2008: "The Lehman Brothers collapse made financial institutions realize that the most precious thing they are entrusted with is trust – and that winning that back was going to take both structural and cultural change that would have been unimaginable just a few years before." So a bank might ask: what do we do that makes us worthy of trust and what do we do that undermines it? In particular, are our behavior and communications well aligned?

- **Borrowers.** What about borrowers? What are their main issues? A classic concern, going back to biblical times, regards interest rates. In today's market, there are credit cards and payday loans that charge astronomical interest rates. Also, how do you avoid lending borrowers too much? What happens if they get in trouble and can't meet payment deadlines? What if they can't repay at all? In my view, virtues like *fairness* and *responsibility* address these situations.
- **Purchasers of Financial Products.** *Fairness* is again important in the case of purchasers of financial products. A common criticism that emerged from the financial downturn was the unfair selling of complex, technical products by many institutions, where the line between financial adviser and retailer was tremendously blurred. Perhaps clients should have sought proper advice, but there's no denying that some banks didn't behave well toward their customers, exploiting their vulnerabilities.

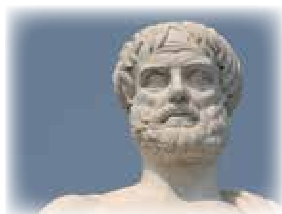
**EMPLOYEES.** Again, banks should treat this important stakeholder group with *fairness*. Employees who are members of professional bodies are a particularly interesting subgroup. Accountants, for instance, are supposed to adhere to certain ethical standards, yet employers might provoke organizational/professional conflict by trying to force them to march to a different beat. Bankers need to be *respectful* of their professional colleagues and the standards that they bring, or should bring, to the business.

**SHAREHOLDERS.** Shareholders didn't fare well in the global financial crisis, unless they sold their assets ahead of the crash. Recklessness and herd behavior on behalf of financial agents were prime culprits – attitudes that rippled across the management hierarchy in some firms. In this case, virtues like *prudence* and *transparency* are important.

However, exercising virtue is easier said than done in some cases, as IESE's Antonio Argandoña noted in "The Financial Crisis: A Search for Ethical Criteria." He wrote: "Prudence, or practical rationality, is the main virtue of bankers and business leaders in general, but it is difficult to exercise it in an environment of high growth, low interest rates and extraordinary opportunities for profit."

**REGULATORS.** Bankers might not support everything regulators do, but I would suggest that they should be *straightforward* in their dealings with them as society's representatives.

I would encourage all banks to go through such an exercise, building on these initial ideas. In thinking about a bank and how it should deal with its stakeholders, notice that I have begun to use words like *trustworthiness, fairness, responsibility, respectfulness, prudence, transparency* and *straightforwardness*. This is deliberate and reflects a turn in moral philosophy back toward the ancient tradition of virtue ethics, associated with thinkers such as Aristotle and Thomas Aquinas. Although such language can be applied to organizations, as I have just done, virtue ethics traditionally relates to individuals. Can we push forward our ethical agenda by thinking about the virtuous individual banker then?





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## Defining the Virtuous Banker

What might a virtuous banker look like? Where might we look for inspiration and guidance in answering such a question?

A little while ago, I asked a similar question about accountants. In coming up with an answer, a couple of things were in the back of my mind.

First, although I have huge respect for philosophical reasoning, I also have a great deal of respect for professionals seeking to do business in the complexity of the real world. I therefore didn't want to take abstract, theoretical concepts and terms and seek to impose them. Instead, I wanted to answer the question using language that accountants would, or should, be familiar with. I was seeking to ground my philosophically informed analysis in their world.

Second, I was conscious that accountants are involved in many different roles in all sorts of organizations; yet I wanted something that could reasonably apply to all of them.

I found my foundation in the code of ethics of the International Ethics Standards Board for Accountants (IESBA). This has been adopted by many professional associations around the world. The code contains five fundamental principles, from which I attempted to infer a set of virtues. That might have been difficult.

EXHIBIT 1

### The Virtuous Accountant: A First Approximation

USING THE IESBA PRINCIPLES, I INFERRED A SET OF CORRESPONDING VIRTUES.

| FUNDAMENTAL PRINCIPLE | ASSOCIATED VIRTUES |
|---|---|
| 1. Integrity | • Straightforwardness<br>• Honesty<br>• Truthfulness |
| 2. Objectivity | • Objectivity<br>• Skepticism<br>• Independence |
| 3. Professional Competence & Due Care | • Competence<br>• Diligence |
| 4. Confidentiality | • Discretion |
| 5. Professional Behavior | • Uprightness |

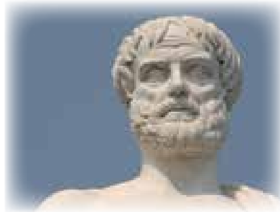
For example, when the code uses the term *integrity*, it doesn't do so in a way that corresponds closely to the philosophical literature or even everyday usage. This becomes clear when you read the code's commentary; yet reading that commentary meant that I could understand what accountants mean by integrity and derive from it certain virtues, keeping close to the code's own language. I proceeded by picking out terms that looked like, or pointed toward, virtues. The full version of my first approximation of the virtuous accountant is shown in **Exhibit 1**.

This is merely illustrative, but it raises three important considerations when formulating a framework for the virtuous banker.

- First, it applies to many types of accountants, even though different roles might call for different weightings and perhaps additional virtues.
- Second, the analysis is grounded in the profession's own language, with minimal imposition of foreign academic terminology.
- Third, although it is based on an ethics code, the analysis includes issues related to competence, which relates to what ethicist Boudewijn de Bruin describes as "epistemic virtues" in his book *Ethics and the Global Financial Crisis: Why Incompetence Is Worse Than Greed*. This combination of competence and ethics is a common theme in sociological accounts of what it means to be a professional. I suggest that any list of characteristics of the virtuous banker should include elements of both ethics and competence. Indeed, the word used by Aristotle, *areté*, can be translated more broadly as *excellence*, which is more than just moral virtue. A further connection, I would add, is that professionals have a moral obligation to be competent.

To answer our question about the virtuous banker, what would be wonderful would be an international resource, similar to the IESBA code, to draw on for bankers. Unfortunately, to my knowledge, no such resource exists. Perhaps that should be on someone's agenda, if it isn't already.

An alternative would be for an individual bank to think about what virtues, or elements of character, it would like to see in its staff, particularly senior bankers. These characteristics should align with things like the bank's





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> Just as a code of ethics needs to be more than just a corporate policy statement, so the description of the virtuous banker needs to be more than just a list of virtues written on a piece of paper.

statement of mission, vision and values, and an understanding of its culture at its best. Some possible candidate words have already been indicated in the consideration of a typical bank's stakeholders. Such a banker profile could be seen as the personification of what the bank aspires to be like.

In the meantime, individual bankers can reflect on what they want to be like. A good starting point might be the cardinal virtues of *prudence, temperance, fortitude* and *justice*, though it would be necessary to think through what these mean in a professional context.

Alternatively, or additionally, the first approximation of the virtuous accountant in the earlier table could be studied as a point of departure; not that bankers are the same as accountants, but they are similar enough for the list in the table to prompt some fertile thinking. And, as previously indicated, the general statements of the banker's employer should be capable of providing food for thought.

Nevertheless, in a sense the issue is not the list itself. As long as it is a reasonably sensible, plausible list, it is likely to be of some value. The key things are the thought that goes into it and the understanding and behaviors that flow from it. Just as a code of ethics needs to be more than just a corporate policy statement, so the description of the virtuous banker needs to be more than just a list written on a piece of paper.

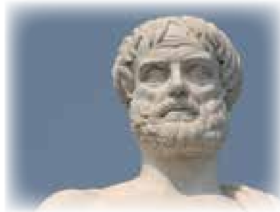
Christopher Cowton (right) addressed ethics in finance during a 25th anniversary CIF event at IESE Madrid moderated by Joan Fontrodona (left) and Antonio Argandoña

## The Benefits of a Virtue Approach

As I mentioned earlier, virtue theory has seen a resurgence in moral philosophy. In itself, though, that is probably of little concern to banks and bankers. However, in everyday life, including everyday business life, people often frame their views in terms of moral virtue. Tom Whetstone, a student of mine at Oxford, was one of the first doctoral researchers to examine virtue in business ethics. He was interested in ethics and virtue, but he didn't want to ask leading questions, so when conducting fieldwork in a U.S. supermarket, he would ask employees, "Who do you consider a good manager around here?" *Good* is a usefully ambiguous word in such a context.

Interestingly, the people the employees admired were not necessarily those who achieved the best results, but those who both did a good job and were fair and supportive of their staff. Moreover, their heroes were frequently their first supervisor, not the chief executive, which is very telling. It was someone they saw consistently putting virtues into practice every day.

Building on this, I would suggest that, in the banking sector, a virtue framework can be beneficial in several ways. For example, in





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reflection and self-development, bankers might ask themselves about virtue *x*:

- Am I *x*?
- When am I at risk of being not-*x*?
- Have I been not-*x* recently? If so, why? What happened?
- How can I become more *x*?
- Do I know someone I admire for being *x*? How could I be more like them?

Similarly, a list of virtues might be used in recruitment and selection, or to help frame a staff development agenda. A consideration of virtues might also lead to questions of relevance to culture. After all, a *good bank* and a *good banker* should be a good fit. Consider these questions:

- Do our remuneration and promotion systems reward or punish the virtues we want to instill?
- Do our top managers emulate the virtues that we claim to uphold (the so-called tone from/at the top)?
- Do we celebrate cases where valued virtues come through strongly?

We often talk about banks and other businesses creating or destroying value. Perhaps we should also ask: (how) do we create or destroy virtue?

## Financial Ethics: Moving Forward

The health of the banking system matters. There's plenty of work for regulators, directors and banks to do in terms of formal regulations, processes and procedures. But many analyses of the financial crisis suggest that at least part of the problem was ethical in nature, which leads us toward a consideration of culture and character.

The great advantage of a virtue approach is that it personalizes things and turns abstract principles – whether philosophical ethics or bank policies – into something tangible to which people can relate. It also means that any banker can get started in thinking ethically about their work, without the need for system-wide progress – though that would help.

Financial ethics isn't just about virtue, though, and there is a massive amount of thinking and development to be done. As an academic body of knowledge, financial ethics is still in its infancy and will likely remain so for a long time. Resources are lacking and I'm not convinced that the academic community is up to the job – certainly not on its own. The insights, resources and energy of bankers are needed.

So, what should bankers do as they wait for the global industry to devise a comprehensive ethics framework of which the notion of the virtuous banker would be part, or from which it could be derived?

In my view, bankers need to reflect on their core activity and ask themselves questions like:

- What does my job look like and what does it mean to do it well?
- What kind of banker do I aspire to be?
- Who do I admire and why? How can I become more like them?

Moral virtues will be part of this, but so will competence – which a banker has a *moral* responsibility to possess, I would argue.

Bankers have not enjoyed much respect of late, but it is a perfectly honorable occupation – or can be. If enough bankers are virtuous, that should be good for all of us. And perhaps it will even reduce the chance of another major financial crisis. ☐

### TO KNOW MORE


- Christopher Cowton gave the opening address "Ethics in Finance: Banking on Virtue?" at an expert panel moderated by IESE professors Antonio Argandoña and Joan Fontrodona to celebrate the 25th anniversary of the Center for International Finance (CIF) at IESE Madrid in June 2018. Read "Deconstructing the Pillars of Finance" about the work of CIF at www.iese.edu/news.
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