University Grants Commission, New Delhi Recognized Journal No. 41311
ISSN: Print: 2347-5021 www.research-chronicler.com ISSN: Online: 2347-503X

Ethics and Corporate Governance in Financial Service Industry

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Abstract

Finance means fund or other financial resources; it deals with matter related to money and the market. People in finance involved in lot of activities which depend not only in handling of financial asset but also involved in using of those asset and taking care of it. However, there are several opportunities in finance for some people to gain at others' expenses. Ethics in finance is not only a concerned for an individual in particular occupation or profession but also for financial services industry.

Financial services would include services rendered by all financial institutions that are engaged in some form of borrowing and lending. In this wide sense, it would include financial intermediaries such as commercial banks, hire purchase finance companies, insurance companies, pension funds and investment trusts. In the context of banking sector, with increasing complexity in the business environment, being ethical is not merely a choice between what is right and wrong, but is more about confronting moral dilemmas in the course of business. Moral bankruptcy is more serious with far reaching consequences than financial bankruptcy. In the present paper, an attempt has been to discuss the unethical practices and causes of frauds existing in banks and to suggest measures prevent and control frauds or to promote an ethical environment with effective and good governance.

Key Words:- Ethics, Corporate Governance and Financial Service Industry

INTRODUCTION

Ethics is said to be the science of morality. The term ethics has originated from the Greek word 'Ethikos' or 'Ethos' which means character, custom, norms, ideas and moral prevailing in a society. Ethics is also defined to mean standardized form of conduct or behaviour of individuals. According to S.K Bhatia "Ethics is said to be aggregate of moral principles or sets of values about what the conduct ought to be. Ethics give an idea what is right or wrong, true or false, fair or unfair, just or unjust, proper or improper, e.g. honesty, obedience, equality, fairness, etc. and respect and then doing the right thing."

Business ethics is nothing but the application of ethics in business. Business ethics is the application of general ethical ideas to business behaviour. It refers to the set of moral values or standards or norms which govern the activities of a businessman. Ethical business behaviour facilitates and promotes good to society, improves profitability, fosters business relations and employee productivity. Ethics and Corporate Governance plays a vital role in financial service industry.

In a broad sense, financial services would include services rendered by all financial institutions that are engaged in some form of borrowing and lending. In this wide sense, it would include financial intermediaries such as commercial banks, hire purchase finance companies, insurance companies, pension funds and investment trusts. In the context of banking sector, with increasing complexity in the business environment, being ethical is not merely a choice between what is right and wrong, but is more about confronting moral dilemmas in the course of business. Moral bankruptcy is more serious with far reaching consequences than financial bankruptcy. In the present paper, an attempt has been to discuss the unethical practices and causes of frauds existing in banks and to suggest measures prevent and control frauds or to promote an ethical environment with effective and good governance.

PUBLIC PERCEPTION OF FINANCIAL SERVICE INDUSTRY

The numerous scams like Harshad Mehta scam, Yes Bank IPO scam, Satyam scam, 2G Spectrum scams are enough to shatter the confidence of an average investor who puts his hard earned money in a wish to earn something more.

Although the finance industry is growing at a multiplier rate with all efforts being directed towards investors security, but the public perception of most financial firms as interested in making money at the expense of all other considerations seems to be unchanging. The financial services sector has an increasingly difficult task balancing the demands of a lengthening list of ‘stakeholders’ - shareholders, the community, investors and pressure groups and demands of the regulator as well.

The agony of public was clearly shown in Anna Hazare’s movement against corruption. The movement led by him clearly showed what the general public feels about the system in general. This clearly indicates the need for Corporates to implement such strategies so as to incorporate ethics and morality among their workforce and overall thinking process of upper level management.

MEAINING OF FINANCE

Finance means fund or other financial resources; it deals with matter related to money and the market. Finance is a science of money. The field of finance refers to the concept of time, money and risk and how they are interrelated. Banks are the main facilitators of funding. Funding means asset in the form of money. It relates to fund raising and fund utilization activities. Finance is the set of activities that deals with the management of funds. It helps in making the decision like how to use the collected fund. It is also art and science of determining if the funds of an organization are being used in a right manner or not.

People trained in finance may enter in to different fields and in different line of work in which they will identify different ethical values followed in different line of work. The situation of a stockbroker is different from that of a mutual fund manager, a market regulator or a corporate financial officer. People in finance involved in lot of activities which depend not only in handling of financial asset but also involved in using of those asset and taking care of it. Everyday billions of financial transaction takes place with a high level of integrity. However, there are several opportunities in finance for some people to gain at others’ expenses. Finance simply concern with other people’s money and other people’s money invites misconduct. Some of the professionals in the financial service whom are bound to serve their clients are as follows they are stockbrokers, bankers, financial advisers, mutual fund, pension manager and insurance agents. Financial manager in corporations, government, and other organizations have to take care of their employers and manage their asset as well. In finance everyone is trusted to carry certain duties from financial analyst to market regulators. Ethics in finance is not only a concerned for an individual in particular occupation or profession but also for financial market and financial services industry.

In this, ethics in finance can be developed around two categories:

1. In financial markets.

2. In financial services industry (including banking and insurance).

ETHICS AND FINANCIAL MARKETS

Financial markets are the bedrock of the financial system. Their purpose is to allocate savings efficiently to parties who use funds for investment in real assets or financial assets. An optimal allocation function will channel savings to the most productive use of those savings. The stakeholders in the financial markets rarely feel the pressure to be morally upright. An external code of conduct is really needed in the financial markets. Introduction of ethics to the financial markets is a very difficult and challenging task. The major aim is to create and maintain the public trust in the financial markets. The professional in the financial markets must give preference to interest of a client than their own interest. Everyone involved in financial markets should act with integrity, impartiality and professional competence. These are generally done under the umbrella of business ethics.

This can be defined as the general action that the financial markets adhere to in the daily conduct of business. It affects how the financial markets deal with the investors. Companies raise money from the investors through the mechanism of financial markets. Therefore, an ethical behaviour on the part of companies is needed. While working through financial markets, the companies must maintain honesty, be fair and humane and must set an example as far as ethical considerations are concerned.

Financial markets worldwide have shown increased connectivity and interdependence. But liberalization of financial markets has raised a number of ethical issues as well. The unethical practices like corruption have also increased manifold. As a result of global financial liberalization, poor nations will be forced to open their markets to financial corporations that will offer undue competition to their local firms and create financial crisis. Financial market instability in the global world poses the greatest danger to developing countries than to the developed countries. There is an urgent need for a global code of ethics to rectify the structural inequalities which may be created by transnational financial institutions planning to operate globally.

ETHICS AND FINANCIAL SERVICES INDUSTRY

In a broad sense, financial services would include services rendered by all financial institutions that are engaged in some form of borrowing and lending. In this wide sense, it would include financial intermediaries such as commercial banks, hire purchase finance companies, insurance companies, pension funds and investment trusts. In this focus will be made on banking industry.

MEANING OF BANKS

Conceptually a bank is known as a financial institution, which serves as a financial intermediary among various components of our society. The primary task of a bank is to accept deposits and provide credits either by lending or through capital market.

"A bank is a financial establishment which uses money deposited by customers for investment, pays it out when required, makes loans at interest" – Oxford Dictionary (2008).

UNETHICAL PRACTICES IN BANKING SECTOR

Unprofessional and unethical practices and behaviour are summarised as the abuse of the confidence, trust and interest the customers and public reposes in the directors, managers and staffs of the commercial banks. These unethical practices are reflected in various forms and levels in the commercial banks Donli (2004), Ayozie (2012), Business Day (2004). Some and by no means the exhaustive unethical practices include the following:

a) Having Undue Access and Tampering with the Customers‟ Accounts: There had been reported cases in the print media, followed by customer complaints against undue access and manipulation of their accounts, both active and dormant, by the bank staffs. Bank staffs engage in unauthorised withdrawals from customer's accounts, unauthorised overdrafts, unauthorised lodgements and operations of the account, fictitious charges, payment of cheques and other banking instruments of commercial bank personnel against customer accounts, and the operation of fictitious accounts, or operating the accounts of dead bank customers. In most case customers that have relocated overseas or to other part, have had their bank account closed or made dormant. Customers who for job loss have not operated their accounts for sometimes, have had their accounts make dormant by some dubious bank workers. To conceal most of these atrocities, commercial bank workers of different cadres engage in the manipulation of book-keepers throw-out-items operated unethically and dubiously just for account reconciliation.

b) Conversion of Cheques or Cheque Conversion: Many bank directors and top management staff have been prosecuted by the Economics and Financial Crimes Commission (EFCC) for this type of sundry offences and others. The bank officials exploited the loopholes in the clearing system to divert funds into accounts other than that of the payee stated in the cheque. The clearing process which is only known to the bank workers, only confirms that the drawer's account is debited and funded. There was no control outside the collecting bank to ensure that the proceed and funds is credited into the right account. Because of the prevalent moral decadence and low ethical standards, this obnoxious malpractice thrives in the commercial banks. Some financial institution and commercial banks engaged in name-dropping of reputable multinational and blue chip companies to raise fictitious commercial papers and the funds are later converted for other personal and non-banking needs.

c) Outright Breach of Trust: Some commercial banks have in the past dishonoured their own manager's cheques.

This exemplifies the poor internal control system of the commercial banks although they might claim to have a genuine reason for their actions. Banks have also out rightly refused to perform on crystallised guarantees, claiming that it will amount to loss.

d) Bank Frauds:

Frauds can be described as a conscious premeditated action of a person or group of persons with the intention of altering the truth and or fact for selfish personal monetary gain. It involves the use of deceit and trick and sometimes highly intelligent cunning skill. The action usually takes the form of forgery, falsification of the documents and signatures. It also involves outright theft. Employees and customers of banks engage in certain degrees of fraudulent practices throughout the world. Fraud is not an inhuman behaviour.

Perry (1984) examined fraud and forgery as not only forging of another person's signature, but also the act of counterfeiting of coin, notes or documents, falsifying a document whether in a material particular or in copying of another person's signature or illegally using another person's signature.

Randiwkz (1979) classified fraud with white collar crime and defined them as illegal acts characterized by deceit and concealment, force or violence or threats thereof within the broad class of white collar crime.

Young (2002) hunted of the ample evidence which exists to show that individual integrity of those managing/running the commercial banks are not a higher level now. Ogwuma (1985) stated that although the existence of frauds in the banks is not an uncommon or unexpected behaviour, its prevalence now is very worrying.

The term fraud is defined in different ways by different authors. Boniface (1991) defined fraud as "any premeditated act of criminal deceit, trickery or falsification by a person or group or persons with the intention of altering facts in order to obtain in due personal monetary advantage. It usually involves the perpetration of some forgery or falsification of documents or illegal authorisation of signature. The certified fraud examines in Adeyemo (2012) defines fraud as illegal acts characterized by deceit, concealment or violation of trust. These acts are not dependent on the application of threat of violence or of physical forces. Frauds are normally perpetrated by individuals and organisations to obtain money, property or services to avoid payment or loss of services or to secure personal or business advantage. The Collens English in Adeyemo (2012) defined fraud as "deceit, trickery, sharp practice or breach of confidence, perpetrated for profit or to gain some unfair or dishonest advantage. Ojo (2008) concluded by stating fraud arises when a person in a position of trust and responsibility digresses from some agreed standards, breaks the rules to advance his personal interest at the expense of the interest of the public (customers). Frauds may be classified as;

a) The insider or non-management frauds are perpetrated by the employees and non-management staff of the commercial banks. This entails the application of fraudulent means to obtain money or other property from the commercial bank.

Boniface (1991) some of the manifestations of employee frauds in the commercial banks includes the following unethical practices;

- Suppression of cash/cheques.
- Computer fraud which takes the form of alteration of the programmes or application packages, or bursting into the computer system through remote sensors. Diskette or flash drives can also be tampered with by bank employees, so as to gain access to unauthorised domains or give credit to accounts for which the funds were not intended. This kind of fraud can remain undetected for a long period of time.
- Diversion of fund by bank staff. Here the bank staffs divert customers' deposits and loan repayments, tap customers funds from interest in suspense accounts from the banks.
- Cash thefts from the ATM machines by banks staff or with connivance by the bank staff.
- Stuffing of fake/counterfeit currency notes in ATM machines by bank employees.
- Forgeries of customer's signatures with the intention of illegally withdrawing money from the account with the bank.
- Using forged cheques to withdraw money from customers' accounts.
- Opening and operating of fictitious account to which illegal transfers could be made and false balances credited.
- Claiming of overtimes for hours not worked.
- Lending to fictitious borrowers affected through fictitious accounts opened at a branch of the bank.

b) Outsider/Insider fraud: This involves a collaboration of bank employees/staff and outsider and customers for the purpose of defrauding the bank. For any bank outsider/customer to succeed, more often than not, there must be an insider who is providing information and other logistic support to the outsiders to succeed. (Adeyemo, 2012).

c) Management fraud: This type of fraud is normally committed by the management staff of the banks, which normally comprise of the board of directors, chairman, directors, managing directors and general manager. This is an embarrassing unethical practice as funds are held in trust for the investors by top management. The victims of this fraud include the investors and creditors, and the medium for perpetrating this fraud is through the financial statement. The reasons for this type of fraud includes the „painting/showcasing the bank in good light in the eyes of the regulatory bodies and the need to pull in more investment from both the existing and potential shareholders of the organisation. Management always commit this fraud which is an unethical conduct.

d) The outsiders frauds are perpetrated by customers and non-customers of the bank and the common methods according to Onkagha (1993) are; advance fee fraud (a.k.a. 419), forged cheques, cheque kitting, account opening fraud, counterfeit securities money transfer fraud, letter of credit fraud and clearing house fraud.

CAUSES OF FRAUDS

The causes of frauds include the unethical involvement of bank staff. The causes can be categorised as Endogenous or institutional factors and Exogenous or environmental factors. The institutional factors are those are traceable to the internal environment of the commercial bank, while the environmental/societal factors include those outside the banking industry.

a) The endogenous/institutional factors which cover the focus of this paper and are unethical practice by the bank staff are;

- Poor book-keeping by bank staff.
- Genetic traits – which are trans-generational (or inherited) attributes possessed by the staff, that propels them (him/her) to engage in bank frauds e.g. some inherited it from their parents, or pathological kleptomaniacs who steals just for the fun of it or for conquest are not suited for professional bank jobs.
- Inadequate infrastructural facilities, e.g. poor communication systems and incessant power failure results to a build-up of unbalance postings.
- The overcrowding of office space(s) encourages staffs to commit bank fraud.
- A weak accounting and poor weak internal control system.
- Ineffective/poor internal auditing system.
- Inadequate supervision of subordinates by superiors.
  - Poor data base management and information communication technology (ICT).
- Conflicting, ineffective, and helpless personnel policies.
- Disparity in the salary structure between certain categories of staff with almost the same qualification.
- Poor salaries and conditions of services.
- General frustrations occasioned by management unfulfilled promises to the staff and the bank union members.
- The employee/staff refuses to abide by laid down procedures, including sound ethical conduct, and most times without any sanction or penalty.
- The commercial bank's reluctance to report fraud and place a disclaimer on convicted ex-staff due to the perceived negative publicity and destruction of the bank brand/image. This encourages more fraud.

(b) The societal/external environmental causes are;

- Slow and tortuous legal processes delays in the prosecution of fraud cases. A frustrated party due to long adjournments and delays might likely abandon a case, and this will lead to miscarriage of justice.
- Non/late reporting of frauds to the police or supervisory bodies.
- Societal emphasises on wealth and money as a symbol of achievement. Ayozie (2012)
- Low societal values/moral.
- Lack of specialised manpower (i.e. forensic investigators) for the investigation of fraud.
- Lack of effective punishment/deterrent.
- Fear of negative publicity to the banks.
- Frequent adjournment of court processes. This might frustrate an applicant and favour the defendant who committed the fraud.
- Fraudulent activities of prosecuting officers and connivance with the judges to release some defendants accused of fraudulent activities.
- Unnecessary and abuse of the plea bargaining process by the bank workers and prosecutors.

PREVENTING AND CONTROLLING BANK FRAUDS / WAYS TO ENCOURAGE ETHICAL ENVIRONMENT

In the light of the various frauds and unethical practices mentioned above, the following measures were recommended in order to prevent and control bank frauds:

1. Hiring honest, genuine, hardworking and sincere people: Banks needs to hire honest and sincere staff, because the cost of hiring a dishonest staff is incalculable, especially to the brand and to the image of the bank. A dishonest staff will undermine any attempt to create a positive work environment and constantly strive to defeat any internal control put in place (Adeyemo, 2012). For this, pre-employment back ground checks, especially the criminal records checks (CRCs), educational history checks, previous employment verification, family background and civil history for possible law suits, will be helpful in hiring honest people. This must be done thrice and not once for a proper honest report which can be used for employment.

2. Exemplary Leadership: The top management of the bank must set an excellent ethical standard to be followed by other bank staff. Every staff no matter how highly placed should be governed by the same ethical standards rules and regulations of the commercial bank, and the banking professional body.

3. There should be adequate and constant training especially in frauds and ethical standards. **4.** The judicial process should be reinforced in the media to encourage speedy hearing of fraud cases, and the publication of such cases will act as a deterrent to other staff, who might wish to engage in fraud.

5. Performing announced and unannounced audits checks (internal and external audits): There should be regular/periodic assessment procedures by all commercial banks, and this must be complemented with uncustomary random announced and unannounced financial audits and fraud assessments (Adeyemo, 2012). This helps to unearth any vulnerability and appraise the effectiveness/effectualness of the existing controls and send the message to all bank employees that fraud prevention and control are of high priority to the commercial bank.

6. Probing every unpleasant major or minor allegations of fraud: A timely, meticulous, and honest investigation of any allegation of commercial bank fraud, direct to internal control and warning signals of frauds will give the indication that frauds are not treated with kid gloves by the commercial bank.

7. Enforcing internal controls: Internal controls should be designed to promote operational efficiency and effectiveness, provide reliable financial information, safeguard assets, and records, encourages adherence to prescribed policies and finally to comply with the regulatory agencies (Adeyemo, 2012). It will also ensure that transactions are valid, properly authorized, properly recorded, properly valued, classified, reconciled to subsidiary records and done by many employees and not carried by a single staff.

8. Establishing a favourable work environment: The setting up of a favourable work environment devoid of rancour, bitterness, and jealousy, encourages a bank staff to follow an established ethical code of conduct, laid down policies and procedures which will make them operate in the best interest of the bank. It opens a line of communication between the employees and management of the commercial banks and guarantees positive staff recognition, sound reward system, greater motivation to perform and productivity. A favourable work environment that has a fair, honest and positive reward system has the tendency of reducing the act of internal and external bank fraud.

CORPORATE GOVERNANCE: AN ETHICAL CODE

Corporate Governance is a voluntary ethical code of business of companies, a system by which companies are directed and controlled. It comprises a set of systems and processes aimed at ensuring that the company is managed to suit the best interests of all stakeholders. Sound corporate governance should provide proper incentives to the board and management to pursue objectives that are in the interests of the company and its shareholders and facilitate effective monitoring (OECD, 2004).

As in any organization, good corporate governance in banks regulates the relationships between banks' stakeholders, their Boards and their management. It prevents the abuse of power and self-serving conduct, restricts imprudent and high risk behaviour by bank managers, and resolves conflicts of interests between managers and board members on the one hand and shareholders and depositors on the other. The current state of the world economy is in some measure attributable to the fact that bank boards did not properly discharge their duties in exercising oversight on managers engaging in high risk activities. The corporate governance of the financial sector clearly has important implications for the stability of the whole economy.

Good governance is decisively the manifestation of personal beliefs and values, which configure the organizational values, beliefs and actions of its Board. The Board as a main functionary is primary responsible to ensure value creation for its shareholders. The absence of clearly designated role and powers of Board weakens accountability mechanism and threatens the achievement of organizational goals. Therefore, the foremost requirement of good governance is the clear identification of powers, roles, responsibilities and accountability of the Board, CEO, and the chairman of the Board. The role of the Board should be clearly documented in a Board Charter.

To sub-serve the above discussion, the following are the essential elements of good corporate governance:

1. Transparency in Board's processes and independence in the functioning of Boards: The Board should provide effective leadership to the company and management for achieving sustained prosperity for all stakeholders. It should provide independent judgment for achieving company's objectives.

2. Accountability to stakeholders with a view to serve the stakeholders and account to them at regular intervals for actions taken, through strong and sustained communication processes.

3. Fairness to all stakeholders.

4. Social, regulatory and environmental concerns.

5. Clear and unambiguous legislation and regulations are fundamentals to effective corporate governance.

6. A healthy management environment that includes setting up of clear objectives and appropriate ethical framework, establishing due processes, clear enunciation of responsibility and accountability, sound business planning, establishing clear boundaries for acceptable behaviour, establishing performance evaluation measures.

7. Explicitly prescribed norms of ethical practices and code of conduct are communicated to all the stakeholders, which should be clearly understood and followed by each member of the organization.

8. The objectives of the company must be clearly documented in a long-term corporate strategy including an annual business plan together with achievable and measurable performance targets and milestones.

9. A well composed Audit Committee to work as liaison with the management, internal and statutory auditors, reviewing the adequacy of internal control and compliance with significant policies and procedures, reporting to the Board on the key issues.

10. Risk is an important element of corporate functioning and governance, which should be clearly identified, analysed for taking appropriate remedial measures. For this purpose the Board should formulate a mechanism for periodic reviews of internal and external risks.

11. A clear Whistle Blower Policy whereby the employees may without fear report to the management about unethical behaviour, actual or suspected frauds or violation of company's code of conduct. There should be some mechanism for adequate safeguard to employees against victimization that serves as whistle-blowers.

CODE OF ETHICS / FUNDAMENTAL PRINCIPLES FOR FINANCIAL SERVICE SECTOR

Certain fundamental principles need to be adhered with for behaving in an ethical manner. These principles have been summarized below –

1. The principle of Integrity – The dictionary meaning of integrity is veracity. Accordingly, the principle calls upon all finance professionals to adhere to honesty and straight forwardness while discharging their respective professional duties. In addition the following acts of responsibility would help comply with the integrity principle;

- Avoid being involved in activities which would impair the goodwill of the organisation.
- Communication adverse as well as favourable information with those concerned.
- Refuse any gift or favour which could influence actions taken or to be taken.
- Refuse to get involved in any activity which would adversely affect the achievement of an organisations objective.
- Avoid conflicts and advice related parties on apparent conflicts which could arise in the future.

2. The principle of objectivity – This principle requires finance professionals to stick to their professional and financial judgement. They should not allow bias, conflicting interests or undue influence of others to override their business judgements. They should communicate information fairly and objectively in such a way that the communication with the end user is complete and transparent.

3. The principle of confidentiality – This principle requires practitioners' financial management to refrain from disclosing confidential information related to their work. Such information may be however be disclosed to their subordinates and care should be taken that the latter maintains confidentiality. The only exception to this principle is when there are requirements to disclose information under a legal obligation or because of some statutory ruling.

4. The principle of professional competence and due care – Finance professionals have a need to update their professional skills from time to time. This has assumed a greater significance in the modern day competitive environment where updated knowledge and skill shall ensure that the client or employer receives competent professional services based upon current and contemporary developments in the related areas.

5. The principle of professional behaviour – This principle requires finance professionals to comply with relevant laws and regulations and avoid such actions which may result into discrediting the profession.

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