Social Capital in Financial Markets: *Trust, but Verify*

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Social capital consists of connections between people and norms of behavior that contribute to social cohesion. Trust and fairness are part of social capital, and social capital matters in economics and finance. Guiso, Sapienza, and Zingales [2008] wrote that "[t]he decision to invest in stocks requires not only an assessment of the risk–return trade-off given the existing data, but it is also an act of faith(trust) that the data in our possession is reliable, that the overall system is fair." They found that people who do not trust the fairness of the stock market are less likely to invest in it.

The law is not sufficient for the creation of social capital since dissonance between the law and perceptions of fairness weakens the legitimacy of the law and reduces the political will to enforce it. Legislators have little political will to enforce laws prohibiting deceptive lending practices when they hear only from lenders who benefit from such practices and from regulators who believe that free markets are always fair markets. Andrews [2008] reported that Alan Greenspan, former chairman of the Federal Reserve Bank, resisted calls for more stringent regulations of subprime mortgages even though the 1994 Home Ownership and Equity Protection Act gave the Federal Reserve authority to prohibit deceptive lending practices.

There is also little political will to enforce insider-trading regulations in countries where a substantial proportion of residents does not perceive insider trading as unfair. Bhattacharya et al. [2000] observed that shares trading on Mexico's Bolsa Mexicana de Valores from 1994 to 1997 did not seem to react to company news. Upon investigation, they concluded that the lack of reaction was due to insider trading. The Mexican law which prohibited insider trading was not enforced, so insiders moved prices ahead of corporate announcements, emptying announcements of news. Subsequently, Bhattacharya and Daouk [2002] extended the analysis to many countries and found that it is the enforcement of insider-trading laws that matters, not the existence of the laws. The cost of capital is lower in countries where insider-trading regulations are enforced.

In this article, I present my findings regarding social capital in financial markets. In particular, I surveyed perceptions of the fairness of insider trading among two segments of the community—finance professionals and university students—in eight countries: Australia, India, Israel, Italy, the Netherlands, Tunisia, Turkey, and the U.S. I found that the majorities of professionals and students in the U.S., the Netherlands, Israel, and Australia considered insider trading unfair, while the majorities of students and substantial portions of professionals in India, Tunisia, Italy, and Turkey considered insider trading acceptable.[1] The remainder of the article is a discussion of social capital as reflected in regulations of insider trading and in the global financial crisis of 2008.

PERCEPTIONS OF FAIRNESS

In order to ascertain differences in perceptions of fairness, my research collaborators and I administered surveys to university students and finance professionals in eight countries: Australia, India, Israel, Italy, the Netherlands, Tunisia, Turkey, and the U.S.[2] After reading vignettes, subjects were asked to rate the fairness of the behavior of the people described in them. Subjects in countries outside the U.S. read vignettes translated into their native languages by my research collaborators and the vignettes were modified to make them appropriate to the locale.

One vignette represented the stylized facts of *United States v. O'Hagan*. James O'Hagan was a partner of Dorsey and Whitney, a law firm that had been retained by the Grand Met Company in July 1988 to help them make a tender offer for the Pillsbury Company. O'Hagan did not work on the Grand Met offer, but overheard it being discussed within his law firm. He opted to act on this information and in August 1988 began purchasing call options and shares of Pillsbury, which he then sold in October 1988 for a $4.3 million profit. Subjects were asked to rate the behavior of Paul Bond, whose behavior was modeled on that of James O'Hagan, using the following question:

Paul Bond is a lawyer at the Brown & Long law firm. One day while standing outside his office at Brown & Long he overheard John Grand, another lawyer at the firm, talking with an associate about his work on a proposed purchase of the Pillow company by the Down company for $120 per share. Paul Bond had no role in the work on the proposed purchase of Pillow and Brown & Long represented only Down, not Pillow. Paul Bond bought 1,000 shares of Pillow for $70 per share. Please rate Paul's behavior as

A. Completely Fair
B. Acceptable
C. Unfair
D. Very Unfair

For each question, I report a "1–4" fairness score, which is a weighted average of responses, where "Very Unfair" is rated 1, "Unfair" is rated 2, "Acceptable" is rated 3, and "Completely Fair" is rated 4.

As reported in Exhibit 1, few U.S. professionals considered Bond's behavior fair. The fairness score assigned to Bond by professionals in the U.S. was 1.30, followed by 1.34 in the Netherlands, 1.76 in Australia, and 1.77 in Israel. Fairness scores assigned to Bond in Italy, Turkey, Tunisia, and India by professionals were higher, ranging from 2.22 in Italy, 2.23 in Turkey, 2.33 in Tunisia, and 2.49 in India. Exhibit 1 also shows that the order of the perceptions of fairness by students in the eight countries was similar to the order of the professionals in those countries. Exhibit 2 shows that the country order of the perceptions of fairness of Bond's behavior generally parallels the country order on the issues of trust and freedom from corruption, two features of social capital.

TRUST, BUT VERIFY

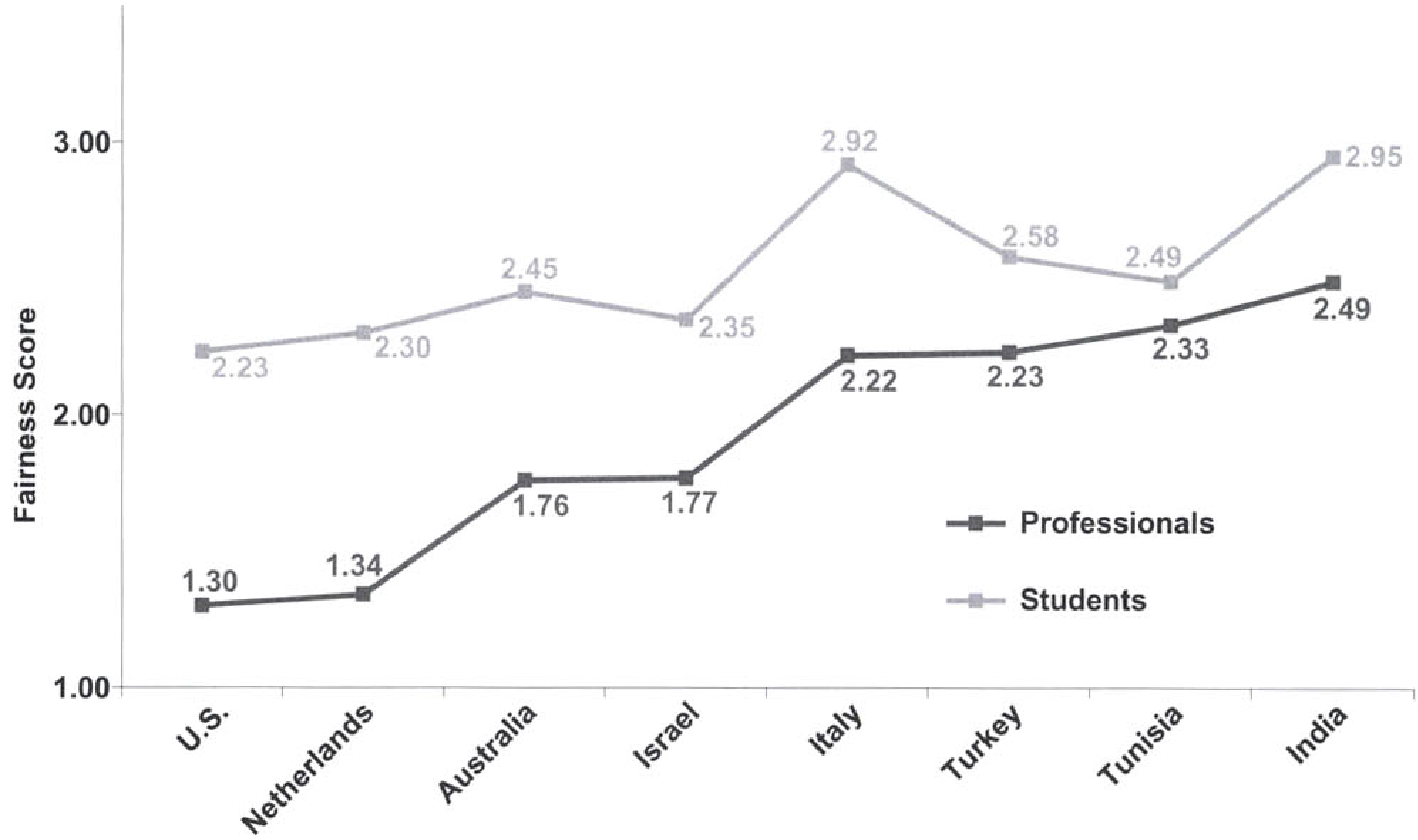
The U.S. has substantial social capital in that it ranked first among the eight countries surveyed in this study on the perception that insider trading is unfair. The U.S. also ranked relatively high on the issues of trust and freedom from corruption, trailing only Australia and the Netherlands. But insider trading in the U.S. is hardly absent. In October 2008, the SEC announced that insider trading cases hit a record during the 12-month period ending September 2008. Insiders caught violating insider-trading laws in the U.S. pay heavy prices, including disgorgement of profits, fines, and prison terms.

Insider traders who have recently been caught include the famous, such as Jeffrey Skilling of Enron and Scott Sullivan of WorldCom, and the obscure, such as David Schwinger of Katten Muchin Rosenman LLP and Joseph Galamb of Hudson United Bankcorp. Insider trading is widespread in many countries other than the U.S., but penalties for violating insider-trading laws in many of those countries are lighter than in the U.S. Italy provides one example. Bagliano, Favero, and Nicodano [2001] found that insider trading in Italy is more rampant than in the U.S., although not as rampant as in Mexico. And Bajo et al. [2008] described the case of Emilio Gnutti, the director of Unipol, the Italian insurance company, who bought 12.7 million of Unipol preferred shares, but disclosed his purchases 42 days late. Mr. Gnutti was fined €150,000, a paltry amount relative to his €4.42 million gain.

In the context of insider trading, even relatively high levels of social capital fail to provide complete protection from violations of the law. Obviously, the U.S., a country perceived as ranking high in terms of trust, freedom from corruption, and other features of social capital, is at the epicenter of the global crisis that took

EXHIBIT 1

Comparison of Countries by Fairness Scores Assigned to Paul Bond by Students and Finance Professionals



Paul Bond is a lawyer at the Brown & Long law firm. One day while standing outside his office at Brown & Long he overheard John Grand, another lawyer at the firm, talking with an associate about his work on a proposed purchase of the Pillow company by the Down company for $120 per share. Paul Bond had no role in the work on the proposed purchase of Pillow, and Brown & Long represented only Down, not Pillow. Paul Bond bought 1,000 shares of Pillow for $70 per share. Please rate Paul's behavior as:

A. Completely Fair
B. Acceptable
C. Unfair
D. Very Unfair

Note: The fairness score is a weighted average such that "Completely Fair" rates 4, "Acceptable" rates 3, "Unfair" rates 2, and "Very Unfair" rates 1.

center stage in 2008 and is still with us today. "Trust" cannot fully replace "verify," and even high levels of trust cannot vanquish the temptations of self-interest. The agency problems discussed by Jensen and Meckling [1976] remain with us.

Still, social capital is useful in managing lending activities, such as those that underlay the global crisis that unraveled in 2008. Ferrary [2003] described the lending activities of French banks, some of which rely on "objective" criteria, such as accounting statements, and others that place more emphasis on "subjective" criteria that is associated with social capital. One such bank noticed that a high percentage of Parisian brasseries were owned by Aveyronais, people from a region in the center of France. Members of this community served as beverage wholesalers, waiters, managers, and even accountants and lawyers associated with Parisian brasseries. The bank integrated itself into the community and benefited from its social capital. Ferrary wrote that

> [t]his strong community integration radically modifies the risk evaluation in this sector. The risk is assessed differently according to whether the borrower is Aveyronais or not. Aveyronais bankers, residing in the Aveyron, grant loans for their Parisian compatriots without looking at the business plan nor visiting the brasseries that they finance (things usually done by a "normal" financial counselor) because they hold

EXHIBIT 2

Ranking of Countries by Trust, Freedom from Corruption, and Perception Insider Trading Is Unfair

Country	Perception by Financial Professionals: Insider Trading is Unfair[1]	Perception by Students: Insider Trading is Unfair[1]	Trust[2]	Freedom from Corruption[3]
U.S.	1	1	3	3
Netherlands	2	2	2	1
Australia	3	4	1	2
Israel	4	3	NA	4
Italy	5	7	5	5
Turkey	6	6	6	6
Tunisia	7	5	NA	7
India	8	8	4	8

[1]*Ranking by fairness scores assigned by financial professionals and students to Paul Bond's behavior;* [2]*Knack and Keefer [1997], data appendix, from World Value Survey and trust and civic cooperation;* [3]*http://www.transparency.org/policy_research/surveys_indices/cpi/2008.*

> enough information on the quality of borrowers and on their families thanks to their belonging to the same social network (p. 680).

Some U.S. financial institutions, just as this French bank, rely on social capital to make crucial decisions. Gross [2008] wrote about community-development banks, credit unions, and other community-development financial institutions that are integrated into their communities, which tend to be low-income communities. Linda Levy, CEO of the Lower East Side Credit Union, described the typical member as "Hispanic women from either Puerto Rico or the Dominican Republic in her [*sic*] late 40s or early 50s, on government assistance, with a bunch of kids." Yet the delinquency rate on the organization's portfolio of mortgage and consumer loans is 2.3%, and it has never had a foreclosure. ShoreBank, a $2.3 billion bank operating in Chicago, Detroit, and Cleveland, makes subprime mortgage loans to low-income families in the community. Only 0.32% of its loans are in foreclosure. ShoreBank goes much beyond collecting monthly mortgage payments by offering free energy audits and free Energy Star refrigerators to homeowners who follow their audits with energy conservation efforts. ShoreBank benefits along with its mortgage customers because lower utility bills make it more likely that customers' monthly mortgage payments will be made. Faith Community United Credit Union, started in the basement of a church in Cleveland, likewise goes beyond making loans by teaching its customers how to manage their finances.

Most U.S. banks were not as integrated into social networks as ShoreBank and similar community-development financial institutions, even in the days before mortgages were securitized and sold in tranches. Still, they had good knowledge of the community and strong incentives to extend loans only to worthy borrowers. The casting of mortgage tranches among investors whose information about borrowers extended no further than ratings assigned by agencies distanced financial institutions from social networks. Investment banks such as Lehman Brothers, insurance companies such as AIG, and mortgage companies such as Fannie Mae and Freddy Mac had little sense of what was coming.

CONCLUSION

Should regulations prohibiting insider trading be abolished, or should they be enforced more rigorously? Those who argue for abolishing insider-trading regulations point most frequently to the economic benefits that arise when trades by insiders quickly incorporate information into stock and bond prices, promoting pricing efficiency. Those who argue for enforcing insider-trading regulations more rigorously point most frequently to the unfairness of insider trading, but also to the economic benefits of the regulations. Prohibition of insider trading promotes investor confidence and confident investors are willing to invest in enterprises that provide economic benefits.

Fairness, along with trust and freedom from corruption, is part of social capital, and social capital promotes economic benefits. Social capital varies among countries and perceptions that insider trading is unfair is one of the indicators of a country's social capital. In this article, I have presented surveys of finance professionals and university students about their perceptions of the fairness of insider trading in eight countries: Australia, India, Israel, Italy, the Netherlands, Tunisia, Turkey, and the U.S. I found that countries which ranked high in the perception that insider trading is unfair also ranked high on trust and freedom from corruption, two other indicators of social capital.

Social capital played a central part in the global crisis that began to unfold in 2008. For years, mortgages were issued to homeowners by their local banks that were members of their same community. Bonds of trust and fairness bound together the members of a community, not only because business interactions extended beyond mortgages, but also because social interactions extended beyond business interactions.

Securitized mortgages increased efficiency because they allowed diversification of risks common to a single community, but securitization also frayed the social capital of that community. Mortgage bankers issued mortgages, collected fees, and tossed their mortgages into tranches as one tosses pieces of refuse into a flowing river. It turned out the risk-reducing benefits of securitization were smaller than their social capital costs.

ENDNOTES

[1]This article extends to other countries the U.S. market surveys of Statman [2005]. Statman [2007] discussed a portion of the surveys with a focus on the means to increase social capital.

[2]These surveys are *convenience samples* and were conducted at universities where my collaborators are located and at available forums of finance professionals. Such samples are not as representative as more comprehensive ones, but they are not biased. In 2003, I surveyed students at Santa Clara University and finance professionals in the U.S. In 2004, Warren McKeown surveyed students at RMIT University and finance professionals in Australia; Dhoha Trabelsi surveyed students at the University of Stax and finance professionals in Tunisia; Enrico Maria Cervellati surveyed students at the University of Bologna and I surveyed finance professionals in Italy; Frans Tempelaar and Auke Plantinga surveyed students at the University of Groningen and finance professionals in the Netherlands; and Rony Halman and Ruth Gesser surveyed students at Tel Aviv University and finance professionals in Israel. In 2005, Atakan Yalcin surveyed students at Koc University, and Recep Bildic surveyed finance professionals in Turkey, and A.V. Vedpuriswar surveyed students at ICFAI University and finance professionals in India.

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