Ethical standards and cultural assimilation in financial services

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Introduction

The financial crisis of 2008–09 cast a harsh light upon a number of practices in the financial services sector:

- Subprime mortgage lending;
- LIBOR fixing;
- Forex fixing;
- PPI (Payment Protection Insurance).

And even more recently:

- Mis-selling passive investment vehicles as active fund management.

Widespread concern that the **culture** in Finance is bad

Supervisors note that they cannot rely solely upon formal regulations to moderate such behaviour.
$\Rightarrow$ cultural standards & "*tone from the top*" are critical.

Despite the focus, "cultural failure" seems to be an endemic feature of banking. [e.g. Dudley of NYFed, Pope Francis & Archbishop of Canterbury]

A consensus that executive pay has contributed to problems in the financial sector; and this has led to substantive fines (Forex $10bn, LIBOR $9bn).

Behavioural problems seem specific to banking and linked to 'moral failure'. (e.g. propensity to lie and experimental evidence).

Ethics are *essentially contested*

Despite ease with which commentators identify moral failings, philosophers have been arguing about what is right for more than two millennia.

- **Virtue** (e.g., Aristotle (2009), MacIntyre (2007));
  - For Aristotle, virtue is inconsistent with many commercial activities.
- **Utilitarian tradition** due initially to Jeremy Bentham (2007 [1789]).
  - For Bentham an action is right when it generates an increase in the aggregate level of individual well-being.
- Kantian **duty ethics**, are duties which exist before we understand the context and do not depend upon that context (Kant (2012 [1785]).
  - An example is the duty to tell the truth.
  - We interpret as a duty not to harm the customer.

Kant would never countenance lying; Bentham would accept its desirability in some situations.

Modelling Ethical Dilemmas

- A principal employs two agents to provide a service to consumers.
- There exists a practice, $\mathscr{P}$, which each agent can invoke and which raises profits with some probability.
- $\mathscr{P}$ may harm consumers a lot, or a little.
  - E.g. fix LIBOR; or sell PPI.

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- Senior agents have better knowledge of the harm which can be caused by $\mathscr{P}$.
- Junior agents can observe the adoption decision of their senior.
- The principal can use optimal remuneration contracts to sway the agents' choices.
- Consumers can be sophisticated (maybe as in LIBOR fixing); or naïve (maybe as in PPI).

Behavioural norms may be passed from senior to junior $\Rightarrow$ culture

We study moral agents who subscribe to two ethical traditions

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2. An interpretation of **Kant's duty ethics**;

$$e_{\text{Duty}} \triangleq -E\,[\text{harm to the customer}]\,.$$

Our rationale for modeling ethical choice in this way:

1. Easier to incorporate in an economic model in which actors maximise something.
2. Many modern economists accept Bentham's ethical stance by identifying welfare with aggregate surplus.
3. Several studies indicate that real-world managers use an act-utilitarian yardstick when resolving ethical dilemmas (e.g. Fritzsche and Becker (1984) and the literature which followed).

We cannot adjudicate between different conceptions of right ... but we can generate positive predictions about the real-world impact of managerial morality.

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Morrison & Thanassoulis, 2016

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Experienced agents under-stand what is right

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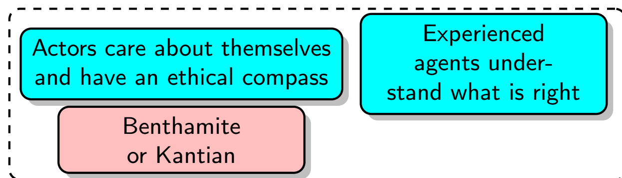

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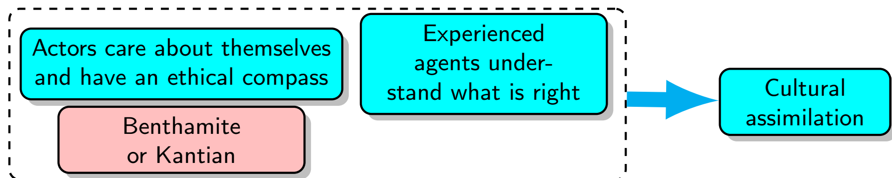

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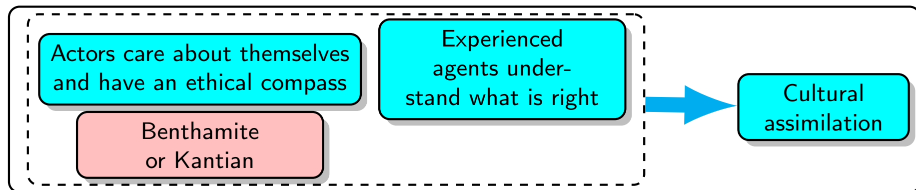

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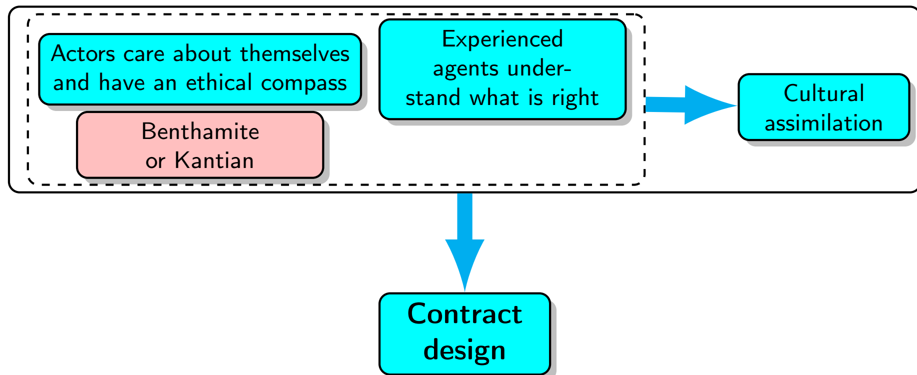

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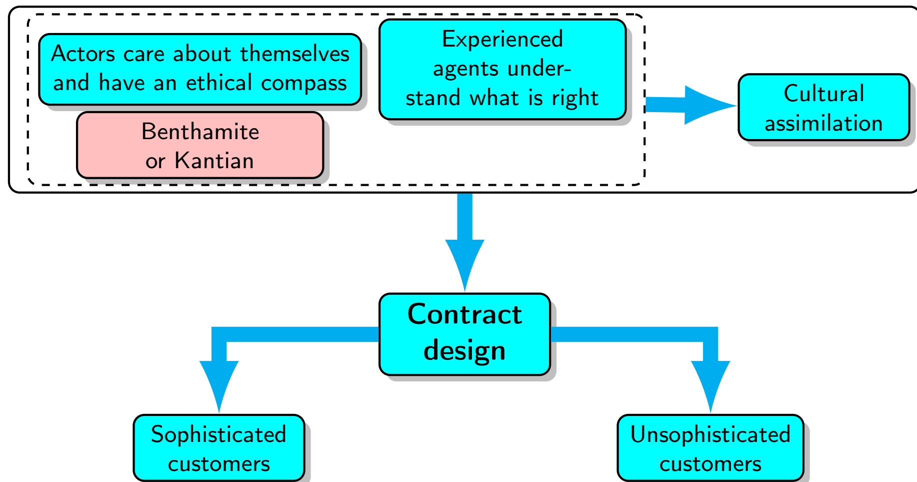

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Findings for sophisticated consumers – e.g. LIBOR

If agents resolve ethical dilemmas using act-utilitarian principles then:

- Principal incentivises **cultural assimilation**.
  Juniors copy adoption decision of the senior agent.
- Principal encourages senior ethical decision and so educates junior.

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For agents who have a duty not to harm consumers then:

- Cultural outcomes are more diverse and depend on parameters:
  1. Cultural assimilation implies senior bonused on own **and** junior's success.
  2. Acceptance and rejection cultures both possible: junior incentvised to ignore senior's adoption or otherwise of $\mathscr{P}$.
- $\mathscr{P}$ is invoked insufficiently from a surplus-maximising regulator's point of view.

Findings for naïve consumers – e.g. PPI

Whatever the ethical tradition followed by the agents,
profits rise as the ethical scruples of the agents decline.

If agents resolve ethical dilemmas using act-utilitarian principles then:

- If the ethics of both agents are weak enough then adoption of $\mathscr{P}$ will exceed the aggregate surplus maximising level.
    - Bonuses for high profits grow.
- **Culture of acceptance** of $\mathscr{P}$ can be dominant when ethics are weak.

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For agents who have a duty not to harm consumers then:

- The full spectrum of cultural outcomes remains possible: cultural assimilation, rejection and acceptance.
- There can be too much or too little of $\mathscr{P}$ for an aggregate surplus maximising regulator.

Related Literature

To our knowledge we're the first to embed philosophical ethics into a contracting model and so study the interaction of ethics, the profit motive, remuneration and culture.

Transmission of cultural norms: Schein (2004), Swidler (1986), and Patterson (2014)

Culture without compensation:Kreps (1990), Crémer (1993), Crémer, Garicano, and Prat (2004), Carillo and Gromb (1999, 2002), Van den Steen (2010a, 2010b)

Compensation without ethics: Inderst and Ottaviani (2009)

Compensation and financial stability: Thanassoulis (2012, 2013), Fahlenbrach and Stulz (2011), and Efing, Hau, Kampfkotter, and Steinbrecher (2015)

Conclusions

PPI selling bonuses appear to be in sharp distinction to those arising in optimal contracting which are designed to provide incentives to overcome a moral hazard problem when managerial effort is not subject to contract.

In our model such bonuses only undermine manager's natural inclination to *do the right thing*.

We don't claim performance pay is never justifiable – **but the decision to use such payments should be weighed against the possible effects they can have on ethical decisions.**

Bonuses in one UK Bank *The Guardian 8 Nov 2012*

"In my role as a customer adviser I had to sell 10 loans a week with seven or eight having PPI ... There was plenty of training in 'disturbance techniques', making the customer feel anxious about their ability to repay the loan in the event of accident, sickness, unemployment or death ... If a customer refused to take PPI we had to explain to the manager the reasons given and which sales objections techniques we used.

Each quarter the branch had to achieve a certain amount of sales points ... Large loans with PPI secured the most points. Our quarterly bonus depended on how many points the branch as a whole achieved. I recall that hitting 120% of target meant our bonus would be in a higher paying threshold.

...

We knew PPI was overly expensive, with some insurances costing £100 a month. There were plenty of other insurances on the market that could offer similar or more suitable cover at a much lower cost."