Ethical standards and cultural assimilation in financial services

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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.
We do not give skin in the game to civil servants, surgeons or teachers; there is a whole range of people who do not have that. It seems to me that you are running what you quite rightly describe as, and are putting huge effort into, a values-based organisation, with a strong values-based culture. Yet, at the end of the day, particularly for your most senior staff who are most important as regards setting values and culture, you seem to be saying that the only way you can motivate them to any significant extent is with cash, deferred or otherwise.
Ethical problems in finance

- Risky mortgages sold to poor and unsophisticated people who did not understand them (Bar-Gill 2009, Agarwal, Amromin, Ben-David, Chomsisengphete and Evanoff 2014)
- Structured products are more complex and have higher “hidden markup” when sold to less sophisticated customers (Céléri and Vallée 2015)
- LIBOR and Forex manipulations generated massive fines of the order of $20bn
- “In the financial sector fraud has become a feature and not a bug” (Zingales 2015)
Emerging themes

1. Formal regulations frequently insufficient to moderate market behaviour
2. Financial institutions frequently appear to foster dysfunctional cultures (Dudley 2014)
3. Executive pay appears sometimes to be a contributory factor
4. Problems in financial markets are widely believed to be associated at least in part with moral failings (Graafland and van de Ven 2011); bankers are more dishonest in professional than personal contexts (Cohn, Fehr and Maréchal 2014)
Theoretical challenges

- Ethics are usually not considered in economic models.
- Hence, work on compensation and short-termism does not directly address ethical conflict (Thanassouliis 2012, 2013; Fahlenbrach and Stulz 2011; Efing, Han, Kampfkotter, Steinbrecher 2015).
- Most economic models of culture view is a positive coordinating device (Kreps 1990; Crémer 1993; Crémer, Garicano, Pratt 2004; Carillo, Gromb 1999, 2002). Hard to understand the link between culture and pay (but see Van den Steen 2010a, b) and little on culture in banking (but see Thakor 2015).
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- Act-utilitarian
- Deontological

Junior takes lead from senior in cultural assimilation.

Sophisticated customers have a willingness to pay that reflects equilibrium choices of other actors. Unsophisticated customers are unable to solve the game.
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Experienced agents understand what is right.

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Cultural assimilation.

Contract design.

Sophisticated customers.

Unsophisticated customers unable to solve the game: fixed willingness to pay.

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Unsophisticated customers
Unable to solve the game: fixed willingness to pay
Institutions and technologies

A business employs a senior agent, s, and a junior agent, j, each of whom provides a service to customers with value $V \sim N(\bar{v}, 1/\tau_v)$ and so generates a profit $\pi \in \{\pi, \bar{\pi}\}$. $P[\pi = \bar{\pi}] = p$; write $\Delta\pi = \bar{\pi} - \pi$.

A new practice $P$ emerges for providing the firm's service. Invoking $P$ raises the probability of high profit to $p + \Delta p$. $P$ could be harmful and impose a cost $c > \Delta p \Delta \pi$ on customers.

$P[\text{P is harmful}] = h$; $P$ is surplus-reductive precisely when $h > \hat{h} = \Delta p \Delta \pi / c$.

The senior agent receives a signal $\sigma$ drawn from $F_H$ if $P$ is harmful, and $F_L$ if it is not; $f_H/f_L$ is strictly monotone increasing with $f_L(1) = 0 = f_H(0)$.

The junior agent observes the senior agent's invocation decision before she makes her own invocation decision. $P$ cannot be contracted upon. Should the firm encourage its adoption?
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- $P$ cannot be contracted upon. Should the firm encourage its adoption?
An agent with lifetime income $w$ who provides a service with value $v$ to customers has objective function $u$:

$$u = (1 - \varepsilon)w + \varepsilon e(w, v).$$

- $e$ is ethical standard
- $\varepsilon \in [0, 1]$ is willpower
Base case: act-utilitarian ethical standard

“Nature has placed mankind under the governance of two sovereign masters, pain and pleasure. It is for them alone to point out what we ought to do, as well as to determine what we shall do. On the one hand the standard of right and wrong, on the other the chain of causes and effects, are fastened to their throne.” (Principles of Morals and Legislation (1789))

\[ e_{\text{Act}} = \mathbb{E}[\text{surplus due to act}] = \mathbb{E}[\text{surplus accruing to bank}] - \mathbb{E}[\text{cost to customer}]. \]
Equilibrium

1. Remuneration contracts \((w^j, w_j)\) and \((w^{sj}, w^s_j, w^i_s, w^r_s)\) between the principal and the agents;

2. A strategy \(\theta_s(\sigma)\) for the senior agent that depends upon her private signal \(\sigma\);

3. Strategies \(\theta_j^1\) and \(\theta_j^0\) for the junior agent in the respective cases where the senior agent does and does not invoke \(\mathcal{P}\).
Behaviour given wage contracts

1. The senior agent's posterior $\eta(\sigma)$ over $P[\text{is harmful}]$ is increasing in $\sigma$.

2. The senior agent has a cut-off strategy: invoke iff $\sigma < \sigma^*$ for some $\sigma^* \in [0, 1]$.

3. Let $h^*_j = \hat{h}_j + 1 - \epsilon_j \Delta p_c(w_j - w_j^*)$. Then the junior agent invokes iff his posterior $h_{Ij}$ over harmfulness given senior agent invocation $I \in \{0, 1\}$ is below $h^*_j$. 

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   Then the junior agent invokes iff his posterior $h^l_j$ over harmfulness given senior agent invocation $l \in \{0, 1\}$ is below $h^*_j$. 
Junior agent strategy regions

$h^*_{j,R}$: junior agent trigger

Cultural assimilation is an equilibrium phenomenon.
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\( h_{j,R}^* \): junior agent trigger

\( \hat{\sigma}, \hat{h} \): surplus-maximising triggers
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\[ h^*_j, R : \text{junior agent trigger} \]

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Acceptance

Rejection
Junior agent strategy regions

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\[ \hat{\sigma}, \hat{h}: \text{surplus-maximising triggers} \]
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Base case

- Profit-maximising principal designs and commits to contracts
- Customers can view contracts
- Customers are sophisticated: they understand the game and can calculate its equilibria
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**Proposition.** With these assumptions, the principal pays the agents their outside option. There are no bonuses, \( \sigma^* = \hat{\sigma} \), and the junior agent’s decision is culturally determined.

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**Intuition.** Bonus payments cause weak-willed agents to take ethically deviant actions. Sophisticated customers anticipate this effect, and reflect it in their willingness to pay. Profit-maximising principals do not pay bonuses, and surplus is maximised. Ethical willpower is irrelevant.
Extension: moral principals

- Contracts designed and executed by moral owner-manager who is the residual claimant on the firm. (Think of partnerships and of profit-sharing directors.)
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Partnerships in this model take actions that are ethically inferior to those they would adopt with profit-maximising NEDs at the helm.
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**Intuition.** The senior agent cannot design a contract under which she does not receive the profits generated by the junior employee. For low willpower junior agents the cost of generating excessive invocation is low enough to render it worth while.
Extension: unobservable wage contacts

- Contracts designed and executed by a profit-maximising principal
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**Proposition.** With these assumptions, the no-bonus no-malpractice equilibrium cannot be sustained if either agent has sufficiently low willpower. The equilibrium involves positive bonuses and excessive invocation of $P$. 
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**Intuition.** If the customers believe that there is no malpractice then it is worth generating it if the cost of incentivising it is low enough: that is, if will power is low enough. The equilibrium could involve cultural assimilation, acceptance, or rejection.
Extension: naïve investors

- Contracts designed and executed by a profit-maximising principal
- Customers can view contracts
- Customers are naïve: their willingness to pay is unaffected by $P$ invocation
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- Customers are naïve: their willingness to pay is unaffected by $\mathcal{P}$ invocation

**Proposition** With these assumptions, the principal sets $\sigma^* > \sigma$ for low enough senior agent willpower. Cultural assimilation, acceptance, and rejection are all possible.

The principal’s expected profits are declining in the agents’ willpower.
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When the customers are naïve, they do not charge the firm for harm. Hence, only the moral concerns of agents prevent it from occurring. If the agents have low enough willpower it is worth inducing excessive invocation; the cost of doing so is increasing in willpower.
We also study duty-driven ("deontological") agents, for whom right need not be driven by surplus-maximising concerns. (Is it right to harm a client if the returns from doing so are very high?) Every type of equilibrium is possible, and invocation below the surplus maximising level is possible. Profits are decreasing in agent willpower.
Extension: duty-driven agents

The will is “a law to itself independently of any property of the objects of volition.” (Groundwork, 1785)

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Predictions and recommendations

First best is achieved with ethical agents, sophisticated customers, a profit-maximising principal without a profit share, and transparency of wage contracts. Removing any of these ingredients leads to excessive invocation of P (with act-utilitarian agents).

Ethical willpower matters only with na"ıve customers, a profit-sharing principal, or opaque contracts. In every case it lowers profits.

We should be careful to distinguish between effort in the sense of "hidden action," and effort in the sense of "selling too many products from a social perspective." When the former is less of a problem the latter becomes a serious concern. We contend that this has frequently been the case in retail financial services markets.

In some markets, product complexity may be a way of turning sophisticated customers into na"ıve customers.
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