Ethical standards and cultural assimilation in financial services

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PPI exposé: how the banks drove staff to mis-sell the insurance

(Hilary Osborne, 8 November 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.

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 (Célérier 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 contets (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 (Thanassoulis 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 2010*a*, *b*) and little on culture in banking (but see Thakor 2015)

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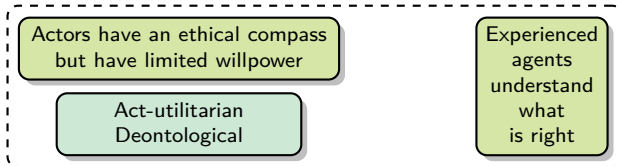Actors have an ethical compass but have limited willpower

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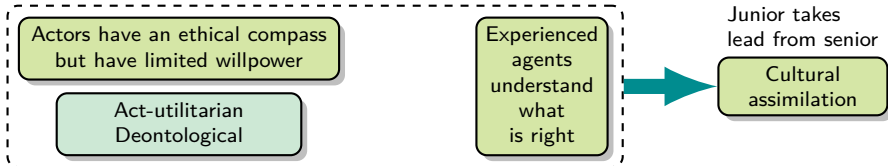Deontological

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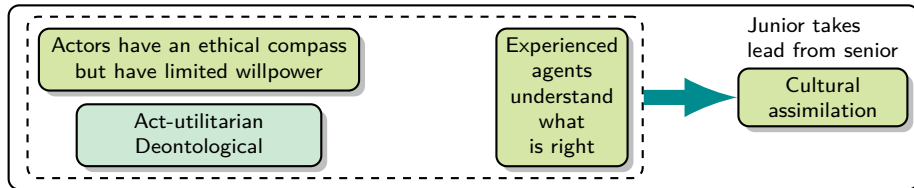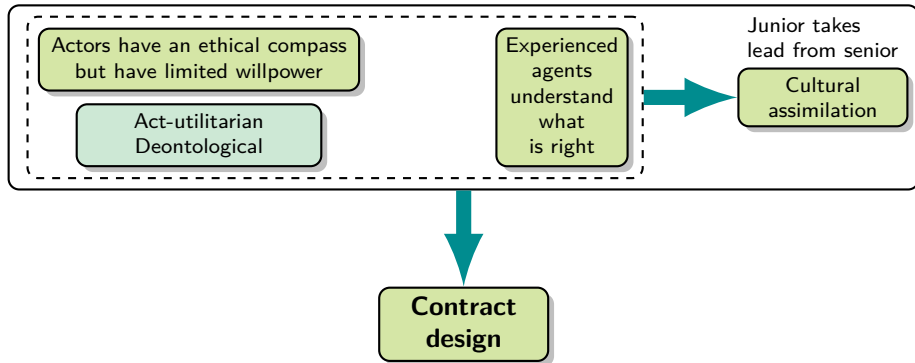
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Sophisticated customers

Willingness to pay reflects equilibrium choices of other actors

Unsophisticated customers

Unable to solve the game: fixed willingness to pay

Institutions and technologies

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▶ A business employs a *senior agent*, s, and *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 $\pi \in \{\underline{\pi}, \bar{\pi}\}$. $\mathbb{P}[\pi = \bar{\pi}] = p$; write $\Delta_\pi = \bar{\pi} - \underline{\pi}$.

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- $\mathscr{P}$ cannot be contracted upon. Should the firm encourage its adoption?

Ethical standards

► 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))

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

Equilibrium

1. Remuneration contracts (w^j, w_j) and $(w^{sj}, w_j^s, w_s^j, w_{sj})$ between the principal and the agents;

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

3. Strategies θ_j^1 and θ_j^0 for the junior agent in the respective cases where the senior agent does and does not invoke $\mathscr{P}$.

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

$$h_j^* = \hat{h} + \frac{1 - \varepsilon_j}{\varepsilon_j} \frac{\Delta_p}{c} (w^j - w_j).$$

Then the junior agent invokes iff his posterior h_j^I over harmfulness given senior agent invocation $I \in \{0, 1\}$ is below h_j^*

Junior agent strategy regions

$h_{j,R}^*$: junior agent trigger
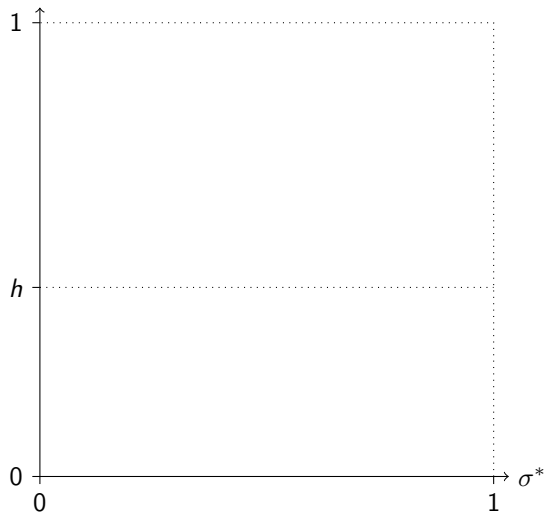
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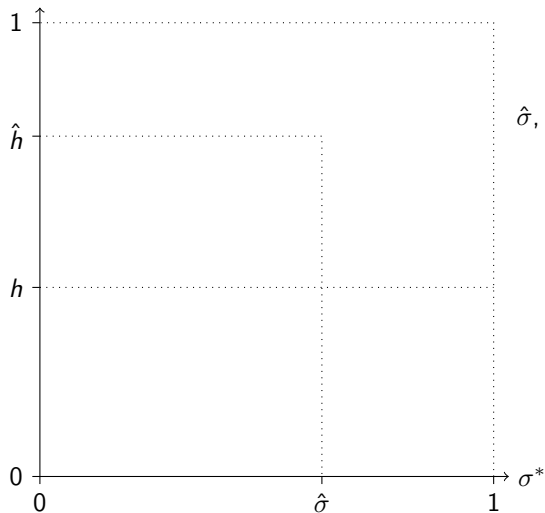
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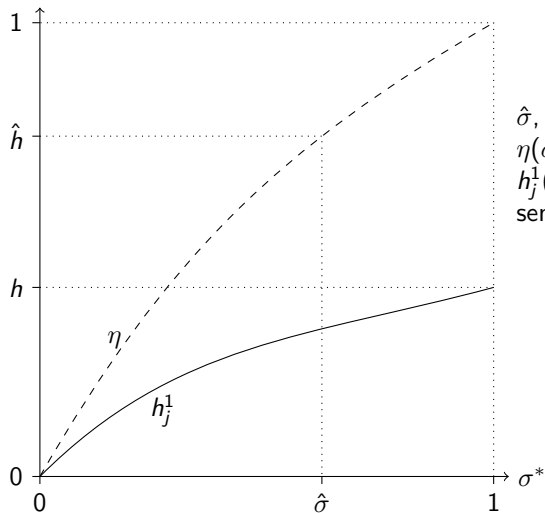
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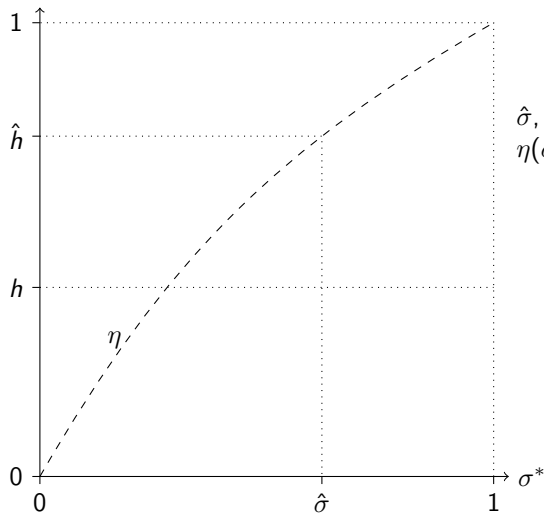
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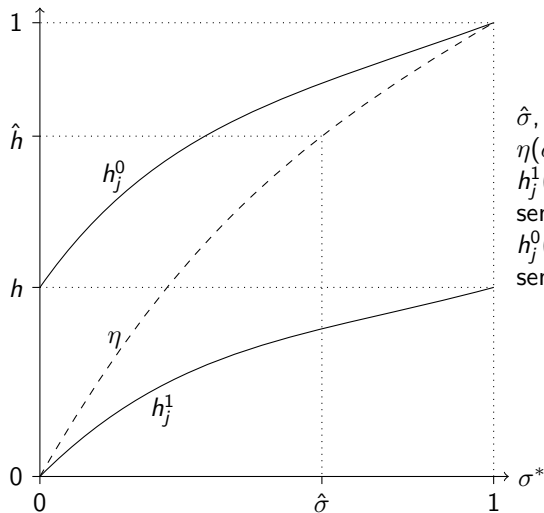$\eta(\sigma)$: senior agent posterior

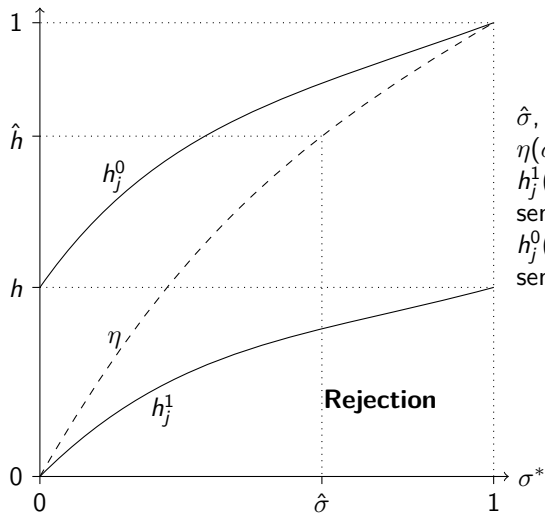# Junior agent strategy regions

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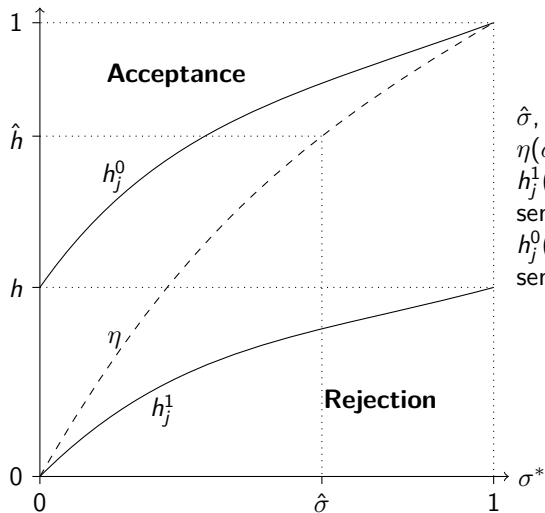
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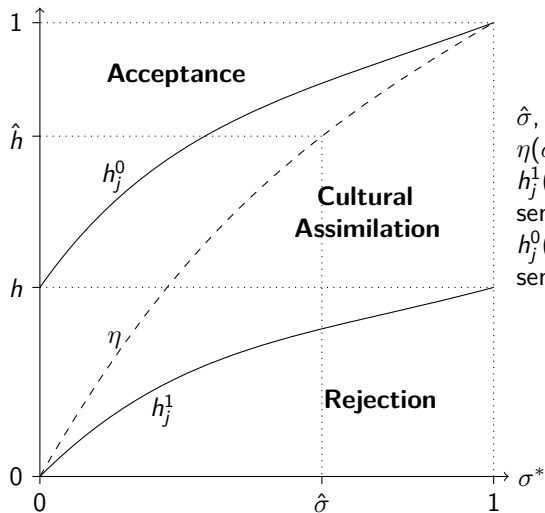
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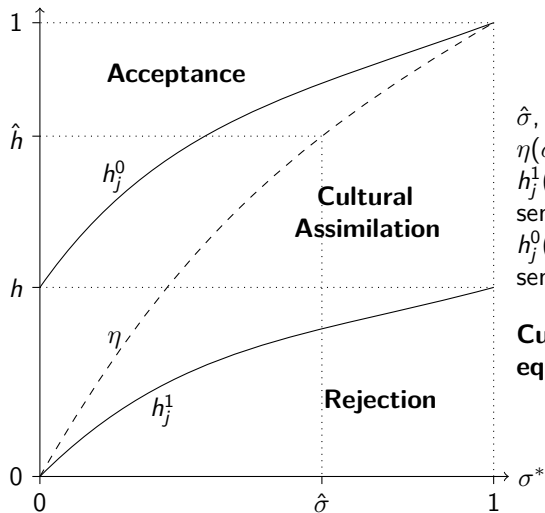
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Cultural assimilation is an equilibrium phenomenon

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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

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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.

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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

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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.
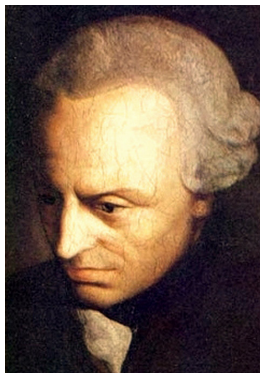
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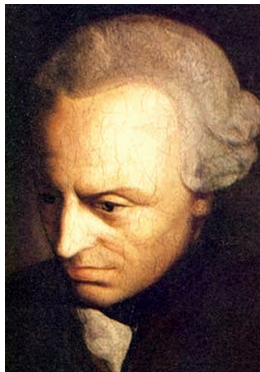
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We also study duty-driven ("deontological") agents, for whom right need not be driven by surplus-maximising concerns. (Is it right to harm a client if the returns from doing so are very high?) Every type of equilibrium is possible, and invocation below the surplus maximising level is possible. Profits are decreasing in agent willpower.

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- In some markets, product complexity may be a way of turning sophisticated customers into naïve customers.