101.

Business Ethics and Compliance
Introduction

On 17 August 2012, ABC News reported that there had been eight “high-profile financial scandals in five months”. The allegations ranged from money laundering by drug gangs to LIBOR rate-fixing and violating sanctions against Iran. Do these events present evidence of a “breathtaking portrait of avarice and deceit” as stated in a Bloomberg editorial (12 July 2012)? Is it a case of customers being seen as means for the enrichment of bank executives? Indeed, in a CBS 60 Minutes interview (21 October 2012), Greg Smith, promoting his book, Why I Left Goldman Sachs: A Wall Street Story stated that it was the top goal of the bank’s sales people to get an unsophisticated client (whom they label a ‘muppet’) and sell him/her their most sophisticated product. It was the best way to make fast money.

Maybe the bank lacked an ethical culture. But what does this mean? Would stronger rules of compliance help to restore ethical behaviour and create less likelihood of fraud by bank executives?

Apparently not.

Indeed in the aftermath of a series of corporate scandals (e.g., Enron, Tyco, WorldCom, Global Crossing etc.) President Bush signed into law the Sarbanes-Oxley Act of 2002, which he characterised as “the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt”. The act provided for a number of reforms to enhance corporate responsibility and financial disclosures, and combat corporate and accounting fraud. In addition, chief executive officers (CEOs) and chief financial officers (CFOs) of public companies must personally certify the accuracy of various financial reports, with significant criminal penalties for false certifications.

But has compliance with Sarbanes-Oxley led to less financial fraud?

A report by the Association of Certified Fraud Examiners (ACFE) found that “the presence of [Sarbanes-Oxley-related] controls was not correlated to a decrease in the median loss for financial statement fraud schemes.”

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Furthermore, even rumours of non-compliance can have devastating effects. For example, on 29 November 2010, the founder of Wikileaks revealed that there was an ‘ecosystem of corruption’ at a major US bank. It was widely suspected that he was referring to the Bank of America. The bank’s share price fell by seven percent.

It would seem that compliance is interpreted as meaning ‘obeying the law to the letter’. The Oxford Advanced Learner’s Dictionary defines compliance as the “practice of obeying rules or requests made by people in authority”. But since rules almost always have some degree of ambiguity – this is the nature of language – compliance itself is determined subjectively.

So what then is ‘ethics’? Ethics is derived from the Greek word ‘ethos’, which translates literally as ‘custom’ or ‘habit’ or a ‘way of living’. What are the drivers of ethical behaviour and, importantly, of ethical decision making in business?

As a start, it is probably not the same as having a set of guidelines that constitute ‘ethical behaviour’. After all, Enron had an ethics handbook where the foreword, signed by its chairman, Kenneth Lay, contained the following paragraph: “We want to be proud of Enron and to know that it enjoys a reputation for fairness and honesty and that it is respected... Let’s keep that reputation high.”

Ethics is what we should do. It is based on a set of values, not rules. But a lack of values will lead to bending the rules. To comply does not necessarily mean that one is ethical. But unethical behaviour leads to non-compliance.

We are reminded of the address by C. S. Lewis at the University of London in 1944, titled “The Inner Ring, Making Good Men Do Bad Things” which predicts the making of a scoundrel: “And then, if you are drawn in, next week it will be something a little further from the rules, and next year something further still, but all in the jolliest, friendliest spirit. It may end in a crash, a scandal and penal servitude; it may end in millions, a peerage and giving the prizes at your old school. But you will be a scoundrel.”

In this module, we posit a link between ethics, trust and performance for financial institutions, and will present greater detail later in this module.

Business ethics is typically defined as “the study of standards of business behaviour, which promotes human welfare”. From an academic standpoint, business ethics involves the systematic study of values – a branch of philosophy – a position that underlines Nash’s classic Harvard Business Review article.† The study of ethics, and business ethics in particular, considers the standards of human behaviour (and business behaviour) based on established moral principles by philosophers.

In its document titled “The Compliance Function in Banks”, the Basel Committee on Bank Supervision (BCBS) states that a bank’s compliance function can be defined as follows:

“An independent function that identifies, assesses, advises on, monitors and reports on the bank’s compliance risk, that is, the risk of legal or regulatory sanctions, financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with all applicable laws, regulations, codes of conduct and standards of good practice.”

The remainder of this module is organised as follows. Chapter 1 deals with moral principles underlying business ethics while Chapter 2 links business ethics to trust. Chapter 3 discusses agency relationships in banking and their implications for business ethics. Chapter 4 shows how to create an ethical bank culture and Chapter 5 considers issues in compliance. This module concludes with a summary and review questions.

* Markkula Centre of Applied Ethics.
Chapter 1:
Moral Principles Underlying Business Ethics

We begin this chapter by explaining the main difference between morals and ethics – necessary for a full understanding of the moral principles that underlie business ethics. Morality is a societal issue and is defined by Erhard et al (2009) as “the generally accepted standards of what is desirable and undesirable; of right and wrong conduct, and what is considered by that society as good behavior and what is considered bad behavior of a person, group, or entity”. However, ethics is focused at the group/individual level. As defined by Erhard et al (2009), ethics is “the agreed on standards of what is desirable and undesirable; of right and wrong conduct; of what is considered by that group as good and bad behavior of a person, sub-group, or entity that is a member of the group, and may include defined bases for discipline, including exclusion”. Specifically, as proposed by Schwartz and Carroll (2003), an action is ethical “when it promotes the good of society or more specifically, when the action is intended to produce the greatest net benefit (or lowest net cost) to society when compared to all of the other alternatives”. A commonly proposed model for the study of business ethics is as follows:

**MOTIVE of DECISION-MAKER leads to CONSEQUENCES**

The underlying moral principles of business ethics are highlighted clearly within this simple model.

First, we consider teleology. The word ‘teleology’ contains the Greek root ‘telos’ meaning ‘end’ and the Greek word ‘logos’ that means ‘science’. This moral principle is also referred to as the ‘theory of consequences’. In other words, the morality of action is judged only by the consequences arising from the action or simply put: the ends justify the means. Teleology places focus on CONSEQUENCES in the above model and it is sometimes called ‘consequentialism’.

But what determines the value of the consequences of an action?

When consequences are valued in a particular way, consequentialism is reduced to what is commonly known as utilitarianism. For example Bentham* views an act as morally right if it provides the greatest good (in terms of pleasure over pain) for the greatest number of people. It is interesting to note that the Association to Advance Collegiate Schools of Business (AACSB), a body that provides accreditation of business school education states that: “the consequentialist approach requires students to analyse a decision in terms of the harms and benefits to multiple stakeholders and to arrive at a decision that provides the greatest good for the greatest number of people”. Similarly, Mill† views moral actions in terms of the ‘greatest pleasure’ principle; an action is morally right if it brings the most people the greatest amount of happiness. In short, a positive outcome is equal to a correct act. The emphasis is on results.

But some economists have advocated shareholder primacy over other stakeholders and that managerial actions should be taken to serve only the interests of shareholders. This point of view is notably espoused by the economist Milton Friedman, who suggested that the only moral obligation of business is to make a profit and obey the law‡.

Another special case of consequentialism, which contrasts with utilitarianism, is egoism. This is a normative theory that stipulates that decision makers have a moral right to act in their own self-interest – that is, self-interest is the guiding principle.

Another branch of moral philosophy is called deontology.

Deontology

Deontology is derived from the Greek root, ‘deon’, which translates as ‘duty or obligation’. Accordingly, this branch of moral philosophy focuses on the intentions or moral duty of the decision maker, rather than on outcomes. For example, the business person does not ask how much profit I made (i.e., the ends), but how did I make this profit (the means)? In deontology, there is a separation between the consequences of an action and the moral principles guiding that action. It does not matter what the consequences of lying are; if your moral principles require that you do not lie, that is all the rationalisation needed. The business decision maker will ask the question: what are my moral obligations?§  This can lead to a dilemma. One answer to this question is provided by Kant§: motive matters most. Doing the right thing is paramount according to Kant. In addition, Kant’s second categorical imperative states (we paraphrase) that an individual (e.g., bank staff) should not use another (e.g., customer) for the former’s private gain.

A Business-Decision Dilemma

We begin with a preamble that will highlight the managerial choice. It is clear that all firms face common constraints to their objectives. These include budget constraints, limited resources,

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* Jeremy Bentham (1748-1832). “The greatest happiness for the greatest number of people works well as a way of doing justice. But utilitarianism concludes that torture is right. One person suffers, but many live more happily as a result.” (Comment by Michael Sandel, BBC News).
† John Stuart Mill (1806-1873)
‡ New York Times Magazine, 13 September 1970. He stated, “In a free-enterprise, private-property system, a corporate executive is an employee of the owners of the business. He has direct responsibility to his employers. That responsibility is to conduct the business in accordance with their desires, which generally will be to make as much money as possible while conforming to the basic rules of the society, both those embodied in law and those embodied in ethical custom”
§ Immanuel Kant’s (1724-1804) categorical imperative is an example of duty-bound morality. In personal ethics, this principle requires that one should not act according to any rule that one would not wish to see universally followed. For example, one should not steal unless one would want to live in a world in which everyone was a thief.
bounded rationality, and decision maker behavioural biases. Other statutory constraints include the Sarbanes-Oxley Act (2002). There are also legal constraints that include legal contracting, fair dealing etc. Financial institutions also face additional constraints. These include Basel III capital regulation and liquidity and leverage standards. All these constraints are common to financial institutions. So here is the question:

Should managers be further constrained by moral duty or obligation (deontology), and accept the consequences of their actions for stakeholders?

OR

Should managers focus only on optimising the consequences of their respective actions (consequentialism)?

Comment

a. If a financial institution chooses the first option, there is an additional issue: is it feasible to supervise deontological behaviour?

b. Does a financial institution actually announce that it is more concerned about the ends and not the means? Or will it just publicly state that it is deontological but its revealed actions indicate that it is consequentialist?

We now illustrate these two approaches to decision making in financial institutions

Open Question #2

We encourage an open discussion on the issues raised by the question posed above. The discussion may be framed further as follows:

Is there a cost to doing the right thing?

Is there a cost to not doing the right thing?

We summarise the key points of deontology, which focuses on MOTIVE in our model:

a) Motives matter most. Doing the right thing is a universal law.

b) Do not use others for your private benefit.

c) Doing the right thing does not depend on whether or not bank staff is incentivised to make a particular product offering.

Ask the question: would you provide the same bank product to the customer if you did not receive a bonus or special recognition? Doing what is right is independent of the bonus or incentive received by bank staff.

* Bounded rationality of decision makers has been advanced by H.E. Simon, who proposed that unconstrained optimisation in economics is not feasible. The consequence is that decision makers employ heuristics to arrive at a decision rather than by strict optimisation.

† ‘In general, these heuristics are quite useful, but sometimes they lead to severe and systematic errors’ Tversky & Kahneman, ‘Choices, Values, and Frames’, American Psychologist, 1984: 341-350.

‡ Basel III is analysed in detail in the intermediate module on retail banking.
Example: (Doing the right thing)

“Axis bank, one of the largest banks in India, decided to remove the pre-payment penalty for mortgages. The bank says it would like to respect the customer’s right to choice if they find a rate advantage, even when they shift the loan to a competitor. The normal penalty in the Indian market, to prevent customers looking for fresh loans at lower rates, is 2 percent.” This example shows how moral obligation to be fair may be supervised – just follow the revealed actions and not the rhetoric.

Example: (Say you have a moral obligation but consider only the bottom line)

Staying in India, Ramlinga Raju, the chairman of Satyam computers, announced on 9 January 2009 that the company’s financial statements were falsified over a period of six years. The share price fell to 11.50 rupees on 10 January 2009, its lowest level since March 1998 and from a high of 544 rupees in 2008. What makes this case interesting from the perspective of business ethics is that on 22 September 2008 (just a few months before its criminal activities were revealed), Satyam Computers won the coveted Golden Peacock global award for excellence in corporate governance. “It is a real honour for Satyam to receive such a prestigious award,” said Srinivas Vadlamani, Satyam CFO. “It is a testament to our efforts to continually innovate and advance corporate governance best practices in our industry and around the world.” All the time, the company’s executives were falsifying its financial statements.

Wolves always come in sheep’s clothing. The declared objective for taking action is not always the true reason. There may be other reasons to advance the manager’s private interest. A. Rahman presented several value-added reasons for mergers and acquisitions. These include economies of scale, economies of scope and acquisition of intellectual capital. Clearly these reasons should lead to an expectation of operational synergies. Yet there are other value-decreasing reasons that are usually not publicly stated. These include empire-building where there is a greater opportunity for indulgence in perquisites or getting bigger just for its own sake, likely because the manager’s compensation is tied to firm size or sales. These value-decreasing objectives are hidden under the rhetoric of shareholder value creation and providing customers with better and more appropriate solutions, rather than just products.

But why does this happen? It can be demonstrated that there is a lack of optimal monitoring of the activities and motives of managers arising from a complex set of agency relationships. This is covered in Chapter 3.

We end this chapter by briefly explaining two other moral principles.

Relativism

This is a moral principle that is based on the premise that an action is judged to be ethical relative to group and individual norms. In this sense, since the frame of reference is evolving, ethical behaviour may change over time as the frame of reference also changes over time. So what is morally right? Ethical relativism would propose that the answer depends on the frame of reference – maybe culture or social norms. As such, there are no absolute moral standards. Maybe it is best told by an ancient Hindu text: Truth is one, though the sages know it variously.

Virtue Ethics

Virtue ethics focuses on the actions of the DECISION MAKER. This moral principle asserts that actions should be based on virtues – a character trait that human beings need to advance. It

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‡ ‘Relativity applies to physics, not ethics.’ – Albert Einstein.
emphasises good character and virtue as the foundation for ethical decision making. In some sense, it focuses on the person rather than the action itself. Virtue ethics is excellently described by Maitland* when he states, "The effective functioning of the economy is not the automatic result of the invisible hand of the market, but instead depends critically on the moral virtues that economic actors bring to the marketplace." In summary, the consideration of character is crucial to ethical decision making.

We now link business ethics to trust by stakeholders.

Chapter 2:

Business Ethics and Trust*

In his book, *The Speed of Trust*, Stephen Covey explores the economics of trust. If trust slows down, consumers slow down their demand for goods and services and hence costs rise. As Neil Fitzgerald, former chairman of Unilever, stated, “You can have all the facts and figures, all the supporting evidence, all the endorsement that you want, but if you don’t command trust, you won’t get anywhere.”

But a recent report from the University of Lancaster Financial Services Research Forum shows that “Mainstream financial institutions – banks, credit card firms, building societies, general and life insurance companies and investment companies – all scored badly.” The score was taken via its trust index.

This is a pessimistic report in view of the importance of ethical behaviour in the financial sector, which is especially important relative to industrial firms. This is because the long-term concern for financial institutions depends not only on financial performance (as it would for all firms) but also on corporate reputation for fair dealing.

But on the positive side, a recent report published by the Chicago Booth and Kellogg School on 24 January 2011 shows, by way of its financial trust index, that trust in banks has risen since the index was published two years ago. The highest level of approval went to banks (43 percent) and the lowest to large corporations (13 percent). What is most interesting is that trust in US banks increased at a steady pace throughout 2010: 34 percent (March 2010); 39 percent (June 2010); 40 percent (September 2010) and 43 percent (December 2010).

This last finding holds promise for the banking sector in the US, since there is evidence that stakeholder trust is the key for long-term financial performance.† The role of business in establishing stakeholder trust is asserted by Khan (2002), who states that ethics in banking leads to trust.‡ But customers are still wary of unethical behaviour by bank representatives. The report finds that “while trust and confidence are steadily increasing overall, [there is] lingering discontent toward mortgage lenders. The new data shows that even people morally opposed to strategic default said they would be more likely to default on their mortgage loan if they knew their lender

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* In the Retail Banking II module titled, “Customer Care” various antecedents of trust are presented.
or bank had been accused of predatory lending." Specifically, "48 percent of Americans said they would be more likely to default if their bank was accused of predatory lending, even if they're morally opposed to strategic default."

This link between unethical practices and trust is most telling, as also asserted by Khan (2002).

The recent financial crisis has revealed numerous instances of overly risky behaviour on the part of bank executives that have had catastrophic consequences for society at large. The consequent loss of trust in banks has led some commentators to observe that "banks have a serious task of regaining the trust of the consumer and rebuilding brand equity."

Indeed, a rumour may spark a bank run. On 8 December 2010, it was reported that an ATM outage at the Bank of Ireland sparked bank-run rumours. Similarly, hundreds of customers descended on branches of Hong Kong’s Bank of East Asia (BEA) to demand their deposits back amid continuing nervousness over the state of global financial markets. The bank said rumours questioning its stability were false and blamed the panic on the circulation of ‘malicious’ mobile phone text messages. The influential Diamond-Dybvig† model shows that bank runs occur because banks convert very liquid deposits to relatively illiquid loans. In their model, deposit insurance helps to lower the likelihood of bank runs. But rumours of financial problems in a bank may lead to the accelerated withdrawal of deposits, which could lead to panic. R.K. Merton in his book, Social Theory and Social Structure, demonstrates how rumours can lead to a self-fulfilling prophecy.

The role of trust in banking has become even more important thanks to the recent financial crisis. Bank regulators and other agencies have strived to develop guidelines to restore trust in banking relations. Indeed, some agencies have recommended that managers declare an oath of fidelity to all stakeholders:

"I declare that I will perform my duties as a banker with integrity and care. I will carefully consider all the interests involved in the bank, i.e., those of the clients, the shareholders, the employees and the society in which the bank operates. In this consideration, I will give paramount importance to the client’s interests and inform the client to the best of my ability. I will comply with the laws, regulations and codes of conduct applicable to me as a banker. I will observe secrecy in respect of matters entrusted to me. I will not abuse my banking knowledge. I will act in an open and assessable manner and I know my responsibility towards society. I will endeavour to maintain and promote confidence in the banking sector. In this way, I will uphold the reputation of the banking profession." §

There are also direct effects on the bottom line of a financial institution. From the perspective of relationship marketing, previous studies have examined trust as a determinant of customer retention and the anticipation of future interaction.

Cross-buying may create perceptions of risk and entail new purchasing decisions of high uncertainty. As such, when customers evaluate a service provider as trustworthy, the perceived uncertainty associated with cross-buying may be reduced.

Indeed, there are several research papers that have established a link between ethical behaviour and its consequent stakeholder trust and financial performance. For example, Maria del Mar Garcia de los Salmones, Andrea Perez, Ignacio Rodriguez del Bosque conclude that "a firm with a correct ethical behaviour and a strong social commitment will be able to achieve better financial results."

* Arup Mukhopadhyay, executive vice president and head of consumer banking at Abu Dhabi, Commercial Bank, Lafferty Retail Banking Book, 201.
‡ Advisory Committee on the Future of Banks in the Netherlands, Restoring Trust, 7 April 2009.
Furthermore, R. Chiami and C. Fullenkamp (2002) * show that trust increases efficiency by reducing agency costs in the complex principal-agent problems that are present in the modern financial institution. There is evidence that business ethics is not just about doing the right thing in a business context, but that it has positive bottom-line effects. We may state that:

“business ethics leads to trust, which leads to improved financial performance.”

This being the case, trust is an asset that is not stated on the balance sheet of the financial institution. As Cruz states in his 2002 book, *Modeling, Measuring and Hedging Operational Risk* (p287), “Trust is an asset”. In addition to that, the practice of business ethics is what creates trust for a financial institution.

In spite of these pronouncements that business ethics is the derivation of trust and the long-term going concern of a financial institution, there are outbreaks of business ethical lapses that have real economic effects – manifested in the recent financial crisis. For what it is worth, Sarbanes-Oxley has been in place since 2002, and Basel II – an upgrade of Basel I – was already implemented in Europe. So what is the problem?

One problem is the complex web of principal-agent relationships that exists between managers in a financial institution and other stakeholders such as shareholders, depositors, debt holders and others. While some of these relationships exist in non-financial institutions, the agency relationship between managers and depositors and managers and supervisors is unique to banks. This sets up interesting ethical considerations which are examined in the following chapter.

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Modern corporations have a separation between managerial control and shareholder ownership. But a problem presents itself: how can owners of a corporation ensure that management is working to further their interests and not their own self-interest? This is called the *agency problem*. This is the case when managers put their own self-interest ahead of owners’ objectives, leading to a cost of conflict borne by shareholders. So why does this ethical dilemma occur? First, we describe the principal-agent model of modern business. The principal (owner) confers authority of control to the agent (managers). The presumption is that managers are paid to work for owners’ interests. But there exists an asymmetry of information about the future prospects of the firm between owners and managers.

It is generally accepted that owners, who are usually passive investors, are at a disadvantage relative to managers who are involved in the day-to-day activities of the firm, set strategic direction, understand the nature of the firm’s competitive landscape and have a better forecast on the future profitability of the firm. Hence, it is relatively more difficult to monitor managers’ activities. As stated by Dees, ‘If such a situation persists, there could be a conflict of interest between managers and shareholders. This is called ‘goal incongruity’. Principal-agent theory (or simply, agency theory) is about how individuals manage situations involving ‘goal incongruity’ between two or more persons.’

To summarise, we quote Jensen and Meckling who define the costs of agency conflict:

“In conclusion, finding that agency costs are non-zero and concluding therefore that the agency relationship is non-optimal, wasteful, or inefficient is equivalent in every sense to comparing a world in which iron ore is a scarce commodity (and therefore costly) to a world in which it is freely available at zero resource cost, and concluding that the first world is non-optimal.”

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* This problem is reduced for institutional investors who themselves have large research departments and so can reduce the degree of information asymmetry between themselves and managers.
‡ It is also described this way: shareholders are interested in market risk while managers are interested in firm-specific risk.
For financial firms, there are several agency relationships based on information asymmetry.

There is the traditional manager-shareholder relationship described above. It is clear that shareholders prefer risk taking since they have limited liability in the corporation. They get all the upside of risk-taking investments but share the loss with debt holders. Hence they expect a higher rate of return based on the level of risk taken by managers*. On the other hand, debt holders prefer stable and adequate cash flow relative to shareholders since debt holders would prefer low-risk investments by managers. This might create a moral hazard for debt holders since managers would prefer to take risky decisions on behalf of shareholders, especially when the equity value of a firm approaches zero. The limited-liability feature of ownership coupled with information asymmetry might permit owners to expropriate wealth from debt holders by increasing risk. This also puts the capital of debt holders at risk†.

There are other agency relationships that are unique to financial institutions. First, there is the relationship between depositors and managers. Depositors‡, especially retail depositors, are diffuse and are less informed about the risk-taking activities of managers. This places their deposits at risk. However, since they typically have a capped deposit insurance, they have less motivation to monitor the risk-taking activities of bank managers. But then the moral hazard falls on the deposit insurer, a government authority, and ultimately on all taxpayers. So in the case of deposit-financing, and coupled with limited liability, the shareholder earns the profit and shares the loss with the taxpayer and the depositor if the loss to the latter is beyond the amount insured.

This leads to another problem. We see that deposit insurance can help to reduce the likelihood of bank runs (Diamond-Dybvig model) but it may also contribute to excessive risk taking by managers. What then is the role of regulation? Research has addressed this problem and there is some consensus§ that capital requirements help to reduce the excessive risk taking created by deposit insurance.

Arguably, managers who are guided by a moral philosophy that is based on the egoistical version of teleology (self-interest) may behave in a manner that is not in the interest of other stakeholders and may even overindulge in perquisites.

This creates a link between business ethics and agency theory.

So far we have concluded that:

- There exists an agency relationship between managers and depositors who cannot optimally monitor the risk-taking activities of managers. This could have the negative consequence of increasing the likelihood of banks runs. Deposit insurance is arguably one solution that protects depositors and reduces the likelihood of bank runs. However, deposit insurance leads to weak depositor monitoring and hence increases the probability of excess risk taking. Capital regulation is viewed as one solution to this problem.

- There exists an agency relationship between managers and shareholders and agency costs arise from cost of conflict. Managers may seek to advance their private interests instead of taking actions to optimise shareholders’ interests.

What is the business ethical issue here?

* As another way to understand this preference by shareholders for risk, we note that shareholders have a call option on the value of the firm with the exercise price being the book value of equity. Hence the option is more valuable with the level of total risk.

† An interesting story was reported in Business Week on 20 September 2004. Titled ‘Frederick W Smith: No Overnight Success’, the story relates how, upon the launch of FedEx, Smith was desperate for cash and on the verge of closing down. He went to Las Vegas and played blackjack. He used his winnings to meet his payroll – the rest is history.

‡ Depositors are of course lenders to banks just like other debt holders. In this module, we separate depositors from lenders of wholesale funding and longer-term debt.

Recall that in teleology the ends justify the means – the concept of consequentialism. But when managers serve their own interests above their contractual obligation – that is, to enhance the interests of the principal – then we are faced with the self-serving moral principle of egoism.

*The lack of optimal monitoring may lead to this ethical problem.*

But this poses an ethical dilemma that underlies the principal-agent relationship. Indeed, if self-interest is the guiding moral principle, then managers may not see an ethical problem and would regard actions that serve the interests of shareholders or depositors or other stakeholders as foolish. Indeed, a paper by Ronald Duska claims that: “To do something for another in a system geared to maximise self-interest is foolish.”

While egoism might explain why managers enhance their private interests against shareholders’ objectives, this behaviour may also be rationalised by opportunism: acting without regard to principle. This unethical behaviour is especially possible when principal-agent relationships are governed by high levels of information asymmetry. This may also account for executives’ overindulgence in perquisites in the presence of excess free cash flow – instead of returning the cash to shareholders in the form of dividends or share buybacks.

Finally, some studies have blamed recent corporate scandals on agency theory underlined by a self-interest (egoism) moral philosophy. (See for example, R. Khurana, N. Nohria, and D. Penrice, ‘Management as a Profession’, in Lorsch, Berlowitz, and Zelleke, (eds.), Restoring Trust in American Business, 2005.)

Indeed, Ghoshal maintains that the teaching of agency theory in business schools is partially responsible for creating the corporate culture that led directly to the scandals. Kulik argued that corruption at Enron was the result of an agency culture that was nourished there.

**Open Question #3**

*Do you think that there is an agency problem between senior bank executives and bank specialists (i.e., risk managers, derivatives traders)? If so, what are the implications for occurrence of ethical violations or corporate fraud?*

We believe that agency theory can give us a theoretical understanding as to why agency cultures exist and how the resulting ethical problem can be identified and resolved. Corporate finance and economics literature have provided an inordinate amount of research showing that agency costs can be mitigated by external interventions. These include using stock options and similar compensation tools to align the interests of shareholders and managers. The general idea is to make managers into shareholders. But as Calvet and Rahman have demonstrated, stock options may have a disincentive effect if managers are too undiversified in the company’s equity.

Corporate finance literature has recommended that dividends or debt be used as tools to reduce excess free cash flows and thereby reduce the likelihood that managers will engage in ‘nest-feathering’ and ‘self-dealing.’ In the case of banks, there is another external intervention where managers must hold capital to cushion unexpected losses arising from, for example, excessive risk taking. However, we now know that Basel II and increased capital regulation and supervision were unable to prevent a serious financial crisis.

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* We discuss the role of governance in another module.
It seems that internal actions to limit unethical behaviour have been crowded out by external incentives aimed at reducing agency costs. In Chapter 1, the central question in business ethics was raised. We now see that external actions and incentives to reduce agency costs are insufficient. External interventions as embodied in Basel III or the Dodd-Frank Act in the United States should be complemented by an answer to the question raised. We now see that the moral principle of utilitarianism (in the sense of Bentham or Mill) is likely to fail because optimal monitoring is probably not feasible in the complex relationship between the various principals (i.e., depositors, regulators, shareholders) and agent. This is especially the case when such relationships are underlined by a high level of information asymmetry. Egoism or opportunism on the part of managers is likely to emerge and agency costs related to overindulgence in perquisites and self-dealing can be high.

Game theory can give us an insight into how egoism (i.e., self-interest) can damage trust between stakeholders.

**The Prisoner’s Dilemma and Trust**

In the Prisoner’s Dilemma, two suspects are accused of jointly committing a crime. The authorities require a confession from either or both of them. They are placed in separate cells so that there is no cooperation between them. The following options are available:

If neither confesses, each will receive a sentence of one year. If one confesses and the other does not, the one who confesses will receive a suspended sentence and the other will receive a long sentence of 15 years. If both confess, each will receive a six-year sentence. We can represent the prisoner’s dilemma game as follows:

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<tr>
<td>Not Confess</td>
<td>(1,1)</td>
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<td>Confess</td>
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The non-cooperative solution to this game is for both to ‘confess’ and each receive six years. This is a solution of minimum security level based on non-cooperation.

*This solution is the best if each player is acting in his/her own self-interest (egoism).*

Unfortunately for ethical egoism, the claim that everyone will be better off if each person does what is in his own interests is incorrect. This is seen as follows:

Suppose that both players agree to cooperate and decide that neither will confess. If this agreement is not abrogated by either suspect, they each will get a one-year sentence (rather than the six years each will get acting under self-interest).†

However, there is an opportunity for each suspect to break the agreement and confess before the sentence is passed. In this case, the suspect who ‘cheated’ on his partner will get a suspended sentence and the other will receive 15 years. This might be the case if each suspect enters into an agreement under false pretence and is only interested in his own self-interest without any regard to the cost to the other party – the end justifies the means.

The lesson here is that suboptimal behaviour is the result of short time-frames and superficial relationships.

But what if each suspect trusts the other because they have a pre-existing relationship? Then a more optimal outcome is possible. This is especially the case if this game is played over time. A

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*This example is discussed in more detail in Luce and Raiffa, *Games and Decisions*, 1957, Section 5.435. Depositors are of course lenders to banks just like other debt holders. In this module, we separate depositors from lenders of wholesale funding and longer-term debt.

† It could be argued that the prisoner’s dilemma presents a conflict between individual and collective rationality.
A trusting relationship emerges and the better solution is identified. This has an important implication for earning customer trust. Superficial relationships and impersonal contact (especially if infrequent) would engender a prisoner dilemma that may lead to suboptimal results. A trusting relationship based on interpersonal contacts that goes beyond the immediate transaction can lead to optimal results.

It is our thesis that the Kantian moral principle of duty and obligation is necessary to complement the external interventions and to resolve the agency problem. The guiding principle is this:

When an opportunity exists for managers to enhance their private interests, managers will not engage in unethical behaviour because it is their moral obligation not to.

The agency problem in financial institutions cannot be resolved by only external actions that align the interests of shareholders and managers (i.e., compensation schemes) or by enhancing compliance to capital regulation or new standards for leverage and liquidity (i.e., Basel III). We must not let external initiatives crowd out internal initiatives that probably have more lasting positive effects. We refer to an ethical code that is not a set of rules of what not to do. Ethics is not compliance with associated penalties. We envisage an ethical culture where the manager knows instinctively what is right.

But there is also a role for the supervision of ethical behaviour. We firmly believe that external mechanisms complemented with an ethical culture will mitigate agency costs and excessive risk-taking. But it is reasonable to assume that opportunism and egoism may still arise in agency relationships. The fallibility of man has been demonstrated by many philosophers. We are reminded of the quote by Samuel Johnson: “Be not too hasty... to trust, or to admire, the teachers of morality; they discourse like angels, but they live like men.” Accordingly, we suggest that supervisors of financial institutions consider auditing ethical culture. The Basel Committee on Supervision mentions that “It is equally important, however, that firms develop a business ‘culture’ that values and promotes not only compliance with the letter of the law, but also a high ethical and investor protection standard.”

Open Question #4

Do you believe that there is information asymmetry between members of the board of directors of a bank and bank specialists (i.e., risk managers)? What are the implications for the occurrence of fraud and the Board’s ability to monitor risk taking in the bank?

In the next chapter, we consider how to recognise this proposed ethical culture and the actions consistent with it.

* The Folk Theorem states that there is a tradeoff between short-term gain and the loss of squandering long-term trust.
Chapter 4:
Creating an Ethical Bank Culture

The concept of a corporate culture was popularised by Deal and Kennedy* (1982) and the current academic and professional literature is replete with several models and approaches that are intended to create strong organisational cultures. As presented in Ravasi and Schultz (2006), we define "organisational culture as a set of shared mental assumptions that guide interpretation and action in organisations by defining appropriate behaviour for various situations." In simple words, and in the context of business ethics and compliance, an ethical bank culture provides a reference against which individual actions and decisions are evaluated on a continual basis. Individuals in a bank look to leadership for guidance on what is acceptable behaviour.

Formally, a corporate culture may be viewed as comprising two main dimensions: an ethical stance and a cultural operational model which specifies corporate values that serve as ethical guidelines for all employees and which are strong enough to discourage distracting sub-cultures arising from cultural silos.

Johnson and Scholes† (1999) state that ‘the ethical stance is the extent to which an organisation will exceed its minimum obligation to stakeholders’. They identify four typologies of an ethical stance. These are as follows:

a) Short-term shareholder interests with a focus on short-term (accounting) profit;

b) Longer-term shareholder interests with a focus on achieving long-term profitable growth;

c) Multiple stakeholder interests, which accept the legitimacy of stakeholders other than shareholders and hence build corporate strategy around this belief;

d) Shaper of society, which transcends stakeholder interests to corporate social responsibility and general societal and humanitarian issues.

It is important to note that these four typologies of an ethical stance are not mutually exclusive and, as an example, a retail bank may choose to adopt multiple stakeholder interests while being

socially responsible. In addition, the term ‘ethical stance’ is not synonymous with business ethics as is defined and discussed in previous chapters. However, without a statement of clarity of ethical stance, bank employees are likely to face ethical dilemmas, since there are inherent conflicts in various stakeholder expectations. Indeed, we have already discussed how an exclusive focus on optimising shareholder interests (short-term or long-term) can lead to excessive risk-taking by managers at the expense of other stakeholders. For example, aggressive cost cutting may improve short-term profitability but may place undue stress on employees. Commission-based selling may increase short-term earnings at the expense of customer satisfaction. Increased risk-taking is likely preferred by shareholders who keep realised profits, but debt holders and depositors prefer cash-flow stability.

Accordingly, it is important that bank executives declare and communicate the bank’s ethical stance to all stakeholders in order to ensure that there is clarity.

The second dimension of an ethical bank culture deals with the bank’s operational model – that is, how to steer the bank operations to achieve its ethical stance. As a background, we note that a retail bank may be viewed as a four-component structure. These components are:

- **Culture**, which is the collective set of core values, beliefs and norms of the bank;
- **Behaviour**, which refers to the individual actions and reactions of employees in their dealings with each other and with customers;
- **Infrastructure**, which is the set of systems and processes that facilitate banking operations; and
- **Tangible or physical**, which refers to the visible aspects (such as bank branches and ATMs) of the bank.

In previous chapters of this module, it was proposed that individual behaviour is determined by the moral principles underlying business ethics. As discussed above, the bank’s culture is the reference framework for all employees. It is a moral compass for each employee of the bank. Indeed, as stated by Kotter (1992) “When people talk of ‘the corporate culture’, they usually mean values and behaviours that are shared across all groups in a firm”. Ethical individual behaviour aligned with a strong bank corporate culture creates an ethical bank culture. As summarised by Philippa Foster-Back, there is a “need for companies and their executives to go beyond formal compliance and to develop an ethics culture within the firm and its decision-making. Without guidance, good people can and do make bad decisions. It is up to the leadership of the firm to create the culture ensuring employees ‘do the right thing, because it is the right thing to do’”. It requires that senior management set the example and relentlessly communicate with all employees the values of the bank.

We now provide some recommendations for the creation of an ethical culture in retail banking.

The Dutch National Bank (DNB) suggests that a ‘values-led corporate culture’ should incorporate seven main elements. These are:

- Balancing of interests/balanced actions: identifying all relevant interests and demonstrably taking them into account.
- Consistent actions: acting in line with objectives and choices.
- Openness to discussion: encouraging employees to take a positive, critical approach and giving scope for discussing decisions, other views, errors and taboos.
- Leading by example: good behaviour at the top (personal integrity, including the prevention of apparent conflict of interests).
- Feasibility: setting realistic targets and removing adverse incentives and temptations.
- Transparency: determining and communicating targets and principle choices to all

‡ Refer to DNB website.
stakeholders.

- Enforcement: attaching consequences to non-compliance.

The DNB views the first two – balanced and consistent actions – as the key to creating a values-led ethical culture. In other words, managers must take responsibility but must also be accountable for their actions. These two elements rest on the foundation of the other five elements in order to meet the ethical challenge.

How can a financial institution create an ethical culture driven by these seven elements?

Here are some examples:

1. Training and communication on conscientious moral judgement.
2. Promoting diversity.
3. Referring back to objectives when making decisions on products, interest rates, remuneration schemes, etc.
4. Training on dilemmas, promoting openness and discussion between employees.
5. Raising employees' awareness of the effects of their behaviour.
6. Giving direct feedback on results of behaviour.

We will now show how to identify key ethical issues in a financial institution and implement a programme as suggested by the Dutch National Bank.

There are, in general, two main approaches to identifying ethical issues in a bank. These are:

a) by stakeholder and consequences; and
b) by values and social expectations.

To identify the ethical issues in the first case, we ask: who might be negatively affected by our decisions – and how and why?

For example, if management decides to close regional branches and substitute ATMs, older customers might find this inconvenient. Our records show that these customers are the main source of the bank's core deposits, which are stable and low-cost. The bank may enhance its cost-income ratio, obtaining higher profitability. But a segment of the bank's customers could be adversely affected. Is this an ethical dilemma? There is conflict in that shareholders are likely better off but a segment of customers who have been the source of the bank's core deposits would be inconvenienced.

In the second case, we ask: what are the social expectations of our business? What actions affect public trust in our organisation?

Overall, all staff must continually ask, what are our values?

Rokeach (1973) presents the following definition:

“A value is an enduring belief that a specific mode of conduct is personally or socially preferable.” Values are internalised as a result of socialisation and personal experience. Over time, they become personal values. Values may also reflect a professional ideal and over time become an organisational value.

The bank's ethical culture must be based on values that are normative standards of what ought to be done. Values play a key role in business ethics.
Values serve as mental frameworks with which people make decisions. The Kantian moral theory requires that there is a moral obligation to do the right thing, in spite of the consequences. People who hold to this value will have no ambiguity in making a decision even if the consequence is harmful.

**Values are also guiding principles used both to make and justify decisions and actions.**

**Values are the key ingredient in making ethical decisions.**

So we may conclude that a 'values-based corporate culture' as espoused by the Dutch National Bank is one that is ethically based. This is because values are derived from moral principles, the foundation of descriptive ethics. But employees may experience a conflict of values and face an ethical dilemma. A classic case is one of a whistleblower. This person is faced with a conflict of values: loyalty to the company and confidentiality versus public good.

Finally, this brings us to the core issue in financial firms. How to make ethical decisions that serve all stakeholders, and reflect the organisation’s values-based corporate culture. Here are the steps to follow:

1. What are the facts?
2. What are the alternatives?
3. What corporate values are in tension?
4. What are the consequences for each alternative?
5. What laws/policies and procedures apply?
6. What are links to the corporate mission and public expectations?
7. Check for emotional awareness, possible pressures and impact of personal interests
8. Ask for advice and engage dialogue
9. Make a decision
10. Verify

Chapter 5: Compliance

This chapter focuses on compliance from a financial services perspective. The International Compliance Association (ICA) defines compliance as “the ability to act according to an order, set of rules or request”. These set of rules, orders or requests provide binding constraints under which all employees of a retail bank must operate with a threat of penalties in response to violation of them. It is noteworthy that while the creation of an ethical bank culture is values-based, compliance has a legalistic tone.

In the context of retail banking, compliance is focused on two levels. Paraphrasing the ICA, Level 1 describes the case where the bank complies with the external rules that are imposed upon it as an organisation, while Level 2 requires compliance with internal systems of control that are imposed by senior executives to achieve Level 1 compliance. This description by the ICA has an important obligation for retail banks: compliance professionals in retail banks must not only interpret and analyse regulations that are established at both a national and global level, but must also create internal policies that are compliant with those laws. This also implies that all businesses within the bank must have a thorough understanding of all applicable laws, regulations and standards in each of the markets and jurisdictions in which the bank operates and, as well, be fully aware of the controls that the bank has in place for compliance.

But compliance is not an end in itself! Here is an important point.

In relation to the goal of creating an ethical bank culture, compliance with applicable laws, rules and standards should NOT be viewed as the end but rather as a means to promote the values of honesty and integrity – hallmarks of an ethical bank culture.

Compliance Risk

The Basel Committee on Banking Supervision (BCBS), in a paper titled “Compliance and the Compliance Function in Banks” (April 2005), defines “compliance risk” as the “risk of legal or regulatory sanctions, material financial loss, or loss to reputation a bank may suffer as a result of its failure to comply with laws, regulations, rules, related self-regulatory organisation standards, and codes of conduct applicable to its banking activities.”
Simply put, compliance risk is the risk of impairment of the bank’s integrity resulting in damage to the bank brand (i.e., reputation risk) as well as sanctions and financial loss that can affect future business with existing clients and create substantial difficulty in acquiring new customers. In this sense, compliance is more than reputation risk since it can have lasting effects on the bank’s integrity and customer trust. Based on this perspective, it is typical for a bank’s compliance function to be part of the strategic risk management framework.

Compliance risk is synonymous with integrity risk.

In scoping compliance risk, the BCBS (2005) states that “compliance laws, rules and standards generally cover matters such as:

a) observing proper standards of market conduct;
b) managing conflicts of interest;
c) treating customers fairly; and
d) ensuring the suitability of customer advice.”

We categorise specific sources of compliance risk as follows:

<table>
<thead>
<tr>
<th>Client-related sources of compliance risk</th>
<th>Business-related sources of compliance risk</th>
<th>Bank-related sources of compliance risk</th>
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<td>Examples include:</td>
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<tr>
<td>• Know your customer</td>
<td>• Behaviour of bank staff (e.g., self-serving)</td>
<td>• Internal controls to meet Level 1 compliance established by Board</td>
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<td>• Money laundering</td>
<td>• Outside positions of bank directors (perceived or real conflict of interest)</td>
<td>• Independence of the compliance function from business units</td>
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<td>• Terrorist financing</td>
<td>• Receipt of gifts or inducements by bank personnel (e.g., perceived quid pro quo)</td>
<td>• Timely reporting of non-compliance incidents</td>
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<tr>
<td>• Transaction monitoring</td>
<td>• Customer interest and protection (e.g., fiduciary responsibility)</td>
<td>• Compliance professionals located in all business units</td>
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<td></td>
<td>• Data security/privacy (e.g., Chinese walls)</td>
<td>• Sufficient funding of the compliance function</td>
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<td></td>
<td>• Marketing and Sales conduct (e.g., mis-selling to customers)</td>
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<td>• Employment practices (e.g., harassment)</td>
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<td>• Transparency of bank products (e.g., products intended to evade tax liabilities)</td>
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Clearly, this table leads to some examples of non-compliance incidents that include the following event types.

- Internal fraud (e.g., by a bank employee)
- External fraud (e.g., money laundering by a bank customer)
- Bank business malpractice (e.g., mis-selling to a bank customer)
- Bank staff malpractice (e.g., harassment of customer or fellow employee by a bank employee)

BCBS (2005) suggests that a separate compliance unit be set up for data protection and for money-laundering and terrorist financing.

Banks have paid substantial fines for money-laundering lapses. Here are some recent headlines:

- “HSBC to pay record $1.9-billion fine in U.S. money laundering case” (*The Globe and Mail*, December 11, 2012);
- “FCA fines Guaranty Trust Bank (UK) Ltd £525,000 for failures in its anti-money laundering controls” (FCA website, 9 August 2013);
- “FSA fines RBS for deficient money laundering controls” (*City AM*, 4 August 2010);
- “Latvian Bank Fined For Magnitsky-Related Money Laundering” (*Radio Free Europe*, 12 February, 2014); and

What is money laundering?

The International Federation of Accountants defines money laundering as “the funneling of cash or other funds generated from illegal activities through legitimate financial institutions and businesses to conceal the source of the funds.” Simply put, ‘dirty’ money is washed ‘clean’.

Research has identified three stages of the money laundering process.

- **Placement** is the process of moving the money from its (illegal) source to financial institutions, casinos, bureaux de change etc.

- **Layering** is the process of making it difficult for a bank (for example) to identify the illegal source. Techniques include electronic funds transfer to jurisdictions with lax record keeping and reporting requirements or into a bank secrecy haven. Layering uses common money market instruments to transfer cash into the desired jurisdiction. The key point is that layering is designed to hamper the audit trail, disguise the origin of funds and provide anonymity.

- The final stage of money laundering is called **Integration**, where the money launderer inserts the funds into the economy without being noticed. This may take the form of consumer spending, investment in the stock markets or in the real economy.

This three-stage process is illustrated as follows:
Legislation in several countries requires financial institutions to conduct transaction monitoring to reduce compliance risk arising from money laundering and terrorist financing. The USA Patriot Act requires that all appropriate elements of the financial services industry report potential money laundering. The Proceeds of Crime (Money Laundering) and Terrorist Financing Act of Canada requires financial institutions to implement specific measures to detect and deter money laundering and the financing of terrorist activities (including establishing record keeping and client identification) and report on suspicious financial transactions and on cross-border movements of currency and monetary instruments. A similar intent is found in The Anti-Money Laundering/Combating Financing of Terrorism Regulations 2009 of Nigeria.

Accordingly, a compliance framework in a retail bank must include all steps to ‘know your customer’ (KYC) and to ‘monitor transactions’ so as to identify anomalous behaviour. Anomalies are unusual or suspicious behaviour that may indicate money laundering and include sudden and large increase or withdrawal of money or moving money to a bank secrecy jurisdiction. Money laundering software may be used to mine customer data so as to identify normal transactions from exceptional (outlier) ones and to comply with regulatory reporting requirements.

In summary, the bank’s chief compliance officer is responsible for setting up an appropriate compliance framework with strict controls to ensure that every bank employee is fully aware of the sources of compliance risks and understands that he/she has a duty to take actions to mitigate them; to report to the board of directors and senior management of non-compliance incidents on a timely basis and to implement changes in compliance standards, rules and standards when required.

At times, compliance professionals can be held personally responsible for compliance lapses.

For example, a recent article provides a stark reminder of the risks a bank, as well as compliance professionals, faces when violations occur. Here is a quote from Dr. Nicole Dando, writing in the Journal of Business Compliance (Volume 2, No. 2), in April 2013:

“On July 17, 2012, the group compliance officer of HSBC dramatically stepped down from his post at a public hearing of the US senate. This resignation was prompted by failures to prevent transactions related to money laundering in Mexico and the illicit concealment of beneficiaries of transfers to Iran and other sanctioned recipients through their US operations. There were no other notable resignations of people in existing executive roles at the bank following this scandal. It was a stark warning to ethics and compliance professionals of the front line nature of the risks they could face, in what is commonly considered a second line of defence; a supervisory function only. Such professionals work at all levels of an organisation and frequently, if not always, have a duty to identify and intervene in potential misconduct – deliberate or accidental.”
Summary

This module dealt with business ethics and compliance. Chapter 1 considered the moral principles underlying business ethics and argued in favour of deontology, where motives matter most when the bank adopts a customer-centric strategy. Chapter 2 established a link between business ethics and customer trust, which is a determinant of customer loyalty necessary for selling other products to the customer.

The next chapter went deeper into why ethical lapses may occur as they have been manifested in mis-selling to customers, bank staff taking actions that are self-serving and a perceived preference for short-termism. The separation of ownership (shareholders) and control (managers) and the resulting information asymmetry provides an opportunity for managers to pursue self-interest objectives. This creates agency costs for shareholders. Unlike non-financial firms, there is a complex web of agency relationships in retail banks and hence it is incumbent on senior management to create an ethical bank culture.

This was discussed in Chapter 4 where it was recommended that the personal ethics of bank staff be aligned with the organisational culture of the bank. The ethical stance of Johnson and Scholes is integrated with a culture model that provides a moral compass for all employees.

Finally, Chapter 5 considered the fundamental issues of compliance risk, which is identified with integrity risk. Compliance lapses by a bank can lead to an impairment of bank brand with a potential to lose future business. Sources of compliance risk were identified and include data security, money laundering and terrorist financing. The crucial role of the compliance department was highlighted in relation to its obligation (as proposed by BCBS [2005]) to identify sources of compliance risk, take actions to mitigate these risks and provide timely reporting on compliance lapses to senior management and the bank board.
Multiple Choice Questions

1. Which moral philosophy focuses on the outcome of business decision making?
   a) Deontology
   b) Teleology
   c) Kantian moral duty
   d) Virtue ethics

2. Research has shown that money laundering comprises three stages. 'The process of making it difficult for a bank to identify the illegal source of funds' is a statement which refers to:
   a) Placement
   b) Integration
   c) Layering
   d) Laundering

3. A client-related source of compliance risk is which of the following?
   a) Independence of the compliance function
   b) Employment practices (e.g., harassment)
   c) Receipt of gifts by bank personnel
   d) Money laundering

4. Agency Theory,
   a) Deals with issues that arise in the principal-agent model
   b) Describes the problems that arise when there is a separation between ownership and control
   c) Shows how some agents may act in their own self-interest
   Choose one of the following:
   I: a) only
   II: a), b) and c)
   III: c) only
   IV: b) only

5. Which of the following agency relationships in a retail bank is mitigated by insurance?
   a) Managers and regulators
   b) Managers and shareholders
   c) Managers and depositors
   d) Shareholders and debt holders

6. A bank has adopted a corporate purpose whereby it wants to be a leader in ethical banking and corporate social responsibility. This bank's purpose is most closely identified with which of the four typologies of the ethical stance by Johnson and Scholes?
   a) Short-term shareholder interests
   b) Long-term shareholder interests
   c) Multiple stakeholder interests
   d) Shaper of society
7. Kantian moral philosophy is mostly related to which of the following?
   a) Teleology
   b) Deontology
   c) Virtue ethics
   d) Relativism

8. Consider the following statements.
   a) Game theory shows that a trusting relationship based on interpersonal contact that goes beyond the immediate transaction can lead to optimal results.
   b) Commission-based selling may lead to unethical actions by salespeople.
   c) The Prisoner's Dilemma business game demonstrates that ethical egoism is suboptimal for all stakeholders.
   d) Information asymmetry likely exists between bank functional specialists and senior bank executives.

Which option comprises only correct statement(s)?
   I. a) only
   II. c) only
   III. a) and c) only
   IV. a), b), c) and d)
   V. a), b) and c) only

9. In the four-component structure of a bank, which component is identified with the phrase ‘a core set of values, norms and beliefs’?
   a) Tangible
   b) Infrastructure
   c) Behaviour
   d) Culture

10. Consider the following scenario: A bank is currently paying a 15 percent commission to its salespeople to sell indexed variable annuities and a 5 percent commission to sell single premium fixed annuities. The variable annuities are indexed to a stock market index but the choice of the index is made by the customer.

Consider the following statements:
   a) The salespeople will most likely assume that the company supports the indexed variable annuity product since it is paying three times more commission compared to the fixed rate annuity.
   b) Salespeople will sell only the variable rate annuity product.
   c) The purely self-interested salesperson will try to sell mostly the variable annuity product.
   d) Ethical salespeople will sell only the fixed rate annuity product.

Choose the option which comprises statements that are mostly likely to describe salespeople’s behaviour.
   I: a) and c) only
   II: a) and b) only
   III: b) only
   IV: a), b), c) and d)
   V: a) and d) only
### Course Code 101 - Business Ethics and Compliance

#### RETAIL BANKING I

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