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EDITORIAL

Behavioural Perspectives on Bank Misdeeds

<u>'Lead us not into temptation'</u>

Economists' analytical viewpoint on behavioural matters, as notably characterised by Gary Becker, the Nobel prize winner, are very different from that commonly expressed by most other commentators. Thus, the economist sees individuals as trying to maximise their utility, based on weighing the benefits of any particular action against the costs of that action. In the case of an action which is illegal and/or disreputable, the cost will relate to the probability of detection of that action interacting with the penalty imposed, if and when caught. The public, however, sees such actions in a rather different light, in the context of culture, ethics and moral values. Thus, discussion of issues such as putting profits and bonuses before the interest of clients, and/or price manipulation of benchmarks for the benefit of the trader, is often described as being the result of 'rotten apples', or even 'a whole barrel of rotten apples'.

There is, however, some greater overlap between these two viewpoints than may appear at first glance, but the overlap is somewhat limited. For example, one of the costs of taking an action that may have a pecuniary benefit for oneself, but which one accepts as being morally wrong, may be that the perpetrator has a personal cost in the form of guilt or shame. That self-assessment will probably, in turn, be significantly affected by how others around one, one's peer group, are responding to the same set of incentives, and this is how 'culture' can enter, somewhat through the back door, see Lo (2015) on 'The Gordon Gekko Effect: The Role of Culture in the Financial Industry'. Social scientists, outside of economics, tend to stress such peer-group, cultural influences on individual decisions. Economists, on the other hand, usually believe that direct personal incentives are more powerful. Indeed, there may even be some who actually find an extra pleasure from 'beating the system'. And almost all of us have limits to the extent that we will do the 'right thing' if the benefits of not doing so are clear and the direct costs of the action seem minimal.

Let me give a personal example. The other week I purchased a return ticket on the Heathrow Express. On the way back, rather late, there was no ticket inspector. But the train company had fulfilled its contract with me, to bring me back after taking me there, and I should, morally speaking, have torn up my return ticket. I did not; in fact at the time I felt pleasure at having saved money. In a very real sense, however, I had defrauded the rail company and my fellow taxpayers. I wonder how many readers would not reuse a return railway ticket which had not been processed. I rather doubt that many would tear up their return ticket under similar conditions.

Let me give a similar example. There was a discussion, involving the then Chancellor Ed Balls, prior to the May 2015 election. The question was whether a payer, asked to make a payment in cash, should request a written receipt from the payee, in order to check (widespread) evasion of VAT? This proposal was widely regarded as implausible. Similarly, the Syriza Government in Greece suggested at one stage that tourists should be encouraged to act as tax inspectors. What that really meant was that tourists should be asked to record and report all cases in which they were specifically asked to pay in cash rather than by some recorded electronic or paper-based mechanism. The aim again was to constrain evasions of VAT. Again that idea was regarded as verging on the ridiculous. There are very few of us, and certainly not including myself, who can claim total moral rectitude. We are, almost all, (utilitarian) sinners, and exhortation to do, or to be, good will have only, in most cases, minor effect.

Such issues arise particularly among professional services. Asymmetric knowledge, which enables the better informed to rip-off the worse informed, is a natural concomitant of professional services; why else go to them? The potential for such rip-offs occur naturally in professional services; have you never wondered whether your dentist, or your garage, is prescribing a more expensive repair than is strictly necessary?

There are a number of remedies for dealing with asymmetric knowledge. These are: Repetition, Reputation, Dual capacity and Design of system. Let me make a few comments about the last three of these. The importance of reputation is clear, and in the case of banks, this would have been well-known to the Board and senior management. A problem is that the reputation of the bank would not have been of much, if any, importance or value to the trader or bank official undertaking the dubious action; particularly if that trader or official was expecting to move from that bank to some other job in the relatively near future.

The usage of dual capacity is a means of trying to defuse the problem of asymmetric knowledge. This is done by separating diagnosis of what may be wrong, and what may be needed, from execution of the necessary act to improve the situation. Thus, if one has an expensive repair to do on one's house, or one's body, or one's asset portfolio, one can call in an expert to advise one on the best course of action, but then state in advance that that course of action will be put out to tender for competition to be done by executive agents other than the initial adviser. The problem with this is that it is extremely expensive, because one is employing two sets of agents for an exercise that could be done by one. Nevertheless, if the exercise is sufficiently important to one's health or wealth, then one usually does use dual capacity, with diagnosis separated from execution. This was the practice in the UK stock market, with brokers separated from jobbers, until the mid-1980s. More generally, in order to save costs, single, rather than dual, capacity has become more general in financial markets. Would it be worth reverting in some cases to a dual capacity system in order to enhance trust in financial markets?

Finally on this topic, let me note that systems can be well, or badly, designed for limiting, or encouraging, bad behaviour. In particular, much of banks' wrong-doing has been related to the manipulation of benchmarks. The provision of benchmarks was entirely unnecessary from the viewpoint of the banks, and the traders within the banks. The purpose of having a benchmark is to provide clients, again who are relatively poorly informed, with an idea of what the normal basic price of an asset was on some particular day. So the exercise of doing such a benchmark was for the benefit of clients, not for the banks themselves. Such benchmarks were extremely badly designed, from the viewpoint of maintaining high standards. They related to the potential price at which an asset could be traded at a particular pre-notified point of time. This was almost an invitation to manipulation.

Again let me give an example. Assume that there is a particular doorway, and you are told that you have to live, forever afterwards, with the first person to come through that door at, say, 4 PM today. Do you not think that, if it was possible, you would try to manipulate the identity of the person coming through that door at that particular time, if you were able to do so? The whole idea of making a particular notional, (not actual), price at a particular single point of the day the focus of a large number of related transactions is inherently stupid. It should not have been too difficult to reform in a high volume, particularly electronic, market. Why cannot the authorities average out the transaction prices in such markets over a short period, with that period varying randomly within, say, the penultimate hour of the market's operations. Supervisors should be trained to assess where the system itself provides an invitation to manipulation. It is easier to reform systems than to reform human behaviour.

'But deliver us from evil'

How should one attempt to design a system that will protect against fraud and immoral manipulation? There are many potential routes; one of these is to check whether there is a sufficient oversight system and then to penalise the manager of the fraudster, as much as the perpetrator. The rationale for this is that the perpetrator will get the benefit, and will then internalise the costs, while the fraudster's manager will not get the benefit. But if the latter has to bear much of the costs, he (or she) will become much more careful to oversee and supervise the trading arrangements in order to ensure that fraud, with its associated costs on the manager if caught, does not occur.

How does one do this? The standard answer is to get *each* manager to sign a document stating that he (or she) has installed and examined sufficient internal controls to prevent fraud and manipulation. This is the general line of attack which has been introduced, for example in New Zealand. The exemplary jail sentence (14 years) imposed in July 2015 on Hayes for rigging the TIBOR benchmark was clearly meant to change the utilitarian calculus of others in the market. It probably will have little success in so doing, for several reasons:-

- In the interim Hayes earned millions, far more than the average worker over several life-times.
- The probability of getting caught and hauled up in court remains minuscule.
- The exemplary sentence was so far out of line with prior norms that it may well get reduced on appeal, and/or early parole will be allowed.

A far greater effect would have been achieved had it been possible to impose a (*much* lower) penalty on Hayes' line-managers for negligence.

Of course, imposing a cost on managers, who would therefore be more careful to prevent fraud, manipulation, etc., could lead the trader to try to collude with the overseeing manager. But apart from the fact that this would spread the financial benefits of the improper behaviour, it would again be necessary to go one step higher and to impose costs on the manager's manager, and so if there is collusion, always go one step higher with the costs. Ultimately one could go as high as the Chairman.

A question that I leave for further consideration, is whether external supervisors, e.g. in central banks and FSAs, should equally be required to make similar attestations. Should the supervisor be asked to sign a statement that they have examined the internal control procedures of the bank that they supervise, and that they have checked and found it satisfactory? Just as the economist would worry about the incentive structure facing the bank official, so we will also worry about the incentive structure facing the supervisors. What, indeed, is the cost/benefit, incentive structure for those working in the PRA/FSA, FCA, etc.?

Essentially, we need better incentive structures throughout. There are a number of steps that could be taken in this respect and some that have been. An example of a revised incentive is the current proposals and requirements for claw-backs in the event that bad behaviour is subsequently identified. But there are further alternative measures that could be taken to improve prudence and better behaviour. Let me mention three.

The first would be to pay bonuses in bail-inable bonds, rather than either in cash or equity.

The second could be to remove limited liability from key decision-makers; not perhaps a complete return to unlimited liability, but to require, say, an uncalled provision to make large payments in cases of losses or fraud for certain categories of senior officials and major decision-makers on the trading floor.

Yet another potential reform, would be to change the governance structure of banks to make them responsive to a wider group of stakeholders and not just to equity shareholders, who have, again because of limited liability, a built-in incentive to encourage greater risk-taking than would be socially optimal. On this latter, see Haldane (2015), 'Who owns a Company?'

The present penalty for bank misbehaviour of imposing massive fines on the banks has no logic either in design nor in outcome. While the fines do encourage top management to introduce stronger internal control mechanisms, it has no effect on the incentives facing the individual on the trading floor. Moreover, the incentive for top management to introduce tougher controls is balanced by the effect of the fines in reducing the capital buffer of the bank, and therefore its ability to intermediate between savers and borrowers. There is a general appreciation of the point that the cost of bad behaviour should impact on the individuals responsible rather than the institution, and that imposing the cost on the institution has probably net negative social value.

Throughout this note I have tried to emphasize the importance of the incentives facing the individual decision-maker, rather than of culture or ethics. Is it better to think as an economist rather than a moralist? Should we try to improve the design of the financial system to reduce the incentives for bad behaviour, rather than to change people, since we all have 'original sin'?

In this respect, I was struck by the proposed individual conduct rules in Box 12 of page 61, of the *Final Report* of the *Fair and Effective Market Review*,

- Rule 1: You must act with integrity.
- Rule 2: You must act with due skill, are and diligence.
- Rule 3: You must be open and co-operative with the FCA, the PRA and other regulators.
- Rule 4: You must pay due regard to the interests of customers and treat them fairly.
- Rule 5: You must observe proper standards of market conduct.
- Rule 6: 'Love thy neighbour as thyself'.
- Rule 7: Always remember to say please and thank you.
- Rule 8: Always wipe your feet after coming in off the street.

The keen-eyed will perhaps have noted that I have added the last three rules myself. But I think that they would probably be as effective, or ineffective, as the first five. We get exhorted notably on Sundays, if we go to church, to behave better. No doubt that helps a bit, but we really need is to structure incentives so that we are not encouraged to behave badly. Such a restructuring remains unfinished business.

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