

THE AMERICAN COLLEGE

PERSPECTIVES ON ETHICAL LEADERSHIP

2011



Eleventh Annual
James A. and Linda R. Mitchell
Forum on Ethical Leadership in
Financial Services



FORUM ON ETHICAL LEADERSHIP

The Eleventh Annual James A. and Linda R. Mitchell/The American College Forum on Ethical Leadership in Financial Services took place on January 22, 2011 in Aventura, Florida. The event featured a discussion of several key issues confronting the financial services industry, along with an examination of practical ethical dilemmas encountered by executives during their careers and questions raised by business ethicists from major colleges and universities around the country.



THE EXECUTIVES

Anthony M. Garcia, President and CEO, TIAA-CREF Life Insurance Company, Charlotte, North Carolina

Jim Mitchell, Chairman and Chief Executive Officer (Retired), IDS Life Insurance Company, Longboat Key, Florida (Host)

Albert J. Schiff, Chief Consulting Officer, NYLEX Benefits, Stamford, Connecticut

Jayne Schiff, Schiff Benefits Group, Greenwich, Connecticut

Peter L. Tedone, President and CEO, Vantis Life Insurance Company, Windsor, Connecticut

THE ETHICISTS

Norman Bowie, Professor Emeritus, Carlson School of Management, University of Minnesota, Minneapolis, Minnesota

Joseph DesJardins, Associate Provost and Academic Dean, College of St. Benedict, St. John's University, Collegeville, Minnesota

Ronald Duska, Director of the Center for Ethics in Financial Services and Charles Lamont Post Chair in Ethics and the Professions, The American College, Bryn Mawr, Pennsylvania (Host)

Kenneth E. Goodpaster, David and Barbara Koch Endowed Chair in Business Ethics, Opus College of Business, University of St. Thomas, St. Paul, Minnesota

John McCall, McShain Chair in Ethics and Professor of Philosophy, St. Joseph's University, Philadelphia, Pennsylvania

Julie Ragatz, Associate Director of the Center for Ethics in Financial Services and Assistant Professor of Ethics, The American College, Bryn Mawr, Pennsylvania

Patricia Werhane, Wicklander Chair of Business Ethics and Executive Director of the Institute for Business and Professional Ethics, DePaul University, Chicago, Illinois



EXECUTIVE SUMMARY

On January 22, 2011 a group of five executives (“practitioners”) and seven academic ethicists (“philosophers”) gathered in Aventura, Florida to participate in the Eleventh Annual James A. and Linda R. Mitchell/The American College Forum on Ethical Leadership in Financial Services.

The purpose of this annual event, established in 2001 by Jim and Linda Mitchell, is two-fold:

- To provide executives with an opportunity to reflect on ethical issues they confront on a regular basis with questions posed to them by academics engaged in business ethics education.
- To afford academics the opportunity to engage in discussion about these issues with top-level executives so they can bring that experience back to their classrooms.

THE ROLE OF THE RECOURSE RULE IN THE MORTGAGE CRISIS

Following the introduction of the participants and discussion of their goals for the day, the conversation turned to the ethical issues posed by the “perverse incentives” created by the Recourse Rule, which some have argued led to the 2008 mortgage crisis. The participants discussed the dilemma faced by individual executives when certain government regulations make it particularly enticing to act for short-term gain rather than in the long-term interests of their shareholders. Some participants argued that if leaders were not held accountable for these decisions, it suggests that they are



The group at the closing reception



compelled to blindly follow where the incentives lead. Moreover, some feared that placing too much emphasis on these sorts of “perverse incentives” might lead to a failure to take into account the poor strategic and ethical decisions made by the banks during the crisis.


Some participants argued that it was necessary to make a distinction between decision makers who had an “ethics problem” and those that had a “competency problem”. Their argument was that the financial crisis was not merely a failure of ethical leadership, but also a failure of sound business sense and adequate risk measurement. However, others challenged this separation between sound business sense and sound ethical decision-making. They argued that risk management, in particular, has a great deal to do with your ethics because it reveals the extent of your commitment to multiple stakeholders.

The participants also addressed the role of regulation within the financial services industry. The participants agreed that regulation should serve two purposes: consumer protection and financial solvency. Participants noted these goals were ethical in nature since, if the financial system is vulnerable to failure, society as a whole is threatened. Some participants warned against the tendency to equate regulatory compliance with ethical behavior since regulations can often produce outcomes which are not only poor for the financial services industry, but also for the consumer as well.

Some participants thought that part of the problem was the process through which regulations are developed and enforced. The participants debated the role of the lobbyists in the process of making laws. Some believed that lobbyists play a necessary role in educating regulators on complex issues. Others were suspicious of the motives of the lobbyists, particularly lobbyists who were former regulators and who found more lucrative employment working for the industry they used to regulate. This “revolving door” may lead to a serious conflict of interest in which the consumer is the one who has the most to lose.

THE ROLE OF CORPORATE BOARDS OF DIRECTORS

The participants considered the role of corporate Boards of Directors, both during the financial crisis and at the present time. The participants agreed that there had been a shift in the ways that corporate Boards of Directors perceived their responsibilities. Part of this shift was the result of the negative publicity that accompanied the revelation of record-breaking compensation packages received



by executives who failed to produce good results. In addition, some of the changes in the corporate boardroom were driven by larger societal shifts in expectations. There was significant pressure to recalibrate compensation to make executives more accountable, and Boards responded to that.

PRACTITIONERS' ETHICAL DILEMMAS

In this segment of the Forum, the executives each presented an ethical situation or problem that they had encountered in their careers.

The first ethical dilemma dealt with an executive who was in the position of Number Two at a company with a unique history. The organization began as a state-sponsored entity and transitioned, about twenty years later, to a stockholder-owned company with a charge to sell dividend-paying insurance. When it became a stockholder-owned company, several individuals put up capital. The company continued to sell only dividend paying policies. By 1996, the company had acquired a surplus of around \$25 million. Did the money belong to those who had originally contributed their capital or did it belong to the policyholders? The executive believed that the arguments of the CEO on behalf of the policyholders were not sound and could jeopardize the future of the company. His dilemma was whether to go to the Chairman of the Board of Directors with his concerns.

The second ethical dilemma concerned a request to fund a popular social event for the senior executives of an agency whose products were represented by the executive's firm. In the executive's opinion, this would not have been a good use of the company's resources for two reasons. The first was that his company did not have a strong market presence in the area. The second is that it didn't make much sense to him to sponsor a lavish event for executives who were already highly compensated. He knew that this decision would be unpopular, but he believed that it was in the best interest of the organization. His dilemma was two-fold: whether to hold this event, knowing he was expected to do so, and how to present this decision to the people involved.

The third dilemma focused on the concerns of a producer who believed that her organization did not have the correct priorities in terms of building and nurturing the client relationship. This was particularly challenging since she was accustomed to working in environments that supported her commitment to extend herself to meet the unique needs and demands of the client. In this particular case, she believed that special attention was warranted because



of both the complexity of the case and the fact that the client was facing a daunting premium increase. Her dilemma was whether she could continue to work for an organization whose policies were not in alignment with her deeply held ethical principles.

The final dilemma considered the decision facing an executive of whether to support a transaction about which he had an intuition that it would not be in the long-term interest of the client. This case posed three challenges: (1) there was more than sufficient business and legal justification for going ahead, (2) the client was a sophisticated institution who had done their own diligence, and (3) most of the people involved were working on a contingency basis and would not receive any compensation for work already performed if the transaction did not happen. While the executive was not in a position to prevent the transaction, he felt morally obligated to share his concerns with the client. He did so and, after a serious conversation, the client decided to postpone the transaction for another year. This turned out to be quite fortuitous since the company was forced to declare Chapter 11 bankruptcy shortly after this event.

PHILOSOPHERS' QUESTIONS

In this portion of the program, each of the academics posed an issue or raised a question for the group to discuss.

The first question considered the conflicting messages that students in a business program receive from their professors. In their ethics courses, students are taught that business decisions should reflect strong ethical values. However, in some other classes, the message is that shareholder value is the only thing that matters, and that having a set of impressive technical skills is all they need to succeed. If this is true, then how do we get ethical responsibilities institutionalized as a norm in the workplace?

The second question concerned whether it was possible to distinguish between financial products that create social value and those products that do not. If the ultimate justification for a financial system is that it functions as a mechanism for allocating capital so that businesses are able to produce and distribute





“And when those around you see that you apply the same ethical matrix to all of your decisions, you begin to create an ethical culture.”

Peter Tedone

goods and services, then it is useful to determine which products achieve this goal and which do not.

The third question considered whether caveat emptor ruled in the stock market. The ethicist shared that most of his students believed that unsophisticated investors should not be involved in the stock market since they were not savvy enough to look out for their own interests. The ethicist questioned whether the executives shared these views.

The fourth question dealt with how the idea of corporate responsibility evolves and takes shape. The academic offered an example of a video game company that was tremendously successful providing a product that most agreed had harmful effects on the people who played it. The challenge was that the company was satisfying all of its stakeholders; employees were happy to work with the latest technology, consumers were delighted with the cutting-edge gaming techniques and provocative subject matter, communities were enjoying increased tax revenues and the shareholders saw the value of their investment increasing. How is it possible to challenge the production of this product on moral grounds if it appears that all of the shareholders are thriving?

The final question explored the “me too” phenomenon, in which employees begin to emulate the behavior of their leadership. This can obviously have both positive and negative effects. The “me too” phenomenon makes it even more important that leaders demonstrate moral courage in their decision-making. How can we increase instances of moral courage? How can we get people to stand up for what they believe is right?



Tony García and Ken Goodpaster listen as Jayne Schiff shares her dilemma



INTRODUCTION AND GOALS FOR THE DAY

The Eleventh Annual James A. and Linda R. Mitchell Forum on Ethical Leadership in Financial Services began by Jim Mitchell asking the participants two questions: What does ethics mean to you in your organization? How do you hope to benefit from today's discussion?

Jim Mitchell said that he had the privilege of working for what he perceived to be two highly ethical organizations. What he learned was that, "if you put the customer first, treat the employees well and are a good citizen of the community, then you will be a highly ethical and highly profitable organization. I saw it happen, I was part of it."

Mitchell added that he and Ron Duska originally organized the Mitchell Forum, in part, to give executives in the financial services industry an opportunity for "organized reflection". He explained that, "It bothers me when I see very senior executives who don't take the time to reflect. How do you know you are doing the right things if you don't step back to think about it?" He also believed that the academic participants would benefit by having the chance "to see a different group of people, most of whom are trying to do the right things, and have the sort of experiences you can take back to your classrooms."

Duska said that he viewed himself as affiliated with three different organizations: The American College, the Center for Ethics in Financial Services and the Society for Business Ethics. Focusing specifically on the Center for Ethics, he shared that its mission is to "improve behavior of practitioners within the financial services industry." He added that this makes sense since, "there doesn't seem to be much point in teaching ethics if it's not going to change some sort of behavior."

He believed the Mitchell Forum is valuable because, "I get tired of executives coming in and giving a talk to ethicists and ethicists giving talks to executives. I think that if we come together to talk to each other, something great will come out of it."

Peter Tedone offered that ethics, "defines the way in which you deal with both the trivial and profound decisions that you have to make. And when those around you see that you apply the same ethical matrix to all of your decisions, you begin to create an ethical culture." When he took on the senior leadership position he holds now, he realized that, "the better way to be a leader was to be consistent and do it right all of the time."

Perspectives on Ethical Leadership



In terms of what he hoped to get out of the day of discussion, Tedone shared that he hoped the group could generate meaningful change in the industry. He believed that “change, whether it’s in an industry or society, doesn’t come when a million people suddenly get together in the same spot at the same time. Change comes when a small group of people get together with a kernel of an idea.”

Joe DesJardins noted that most of the academic participants had taught or were currently teaching at Catholic universities. “The ethical issue that I often think about is the gap between walking the talk. We all talk a good game of ethics, but translating that into practice and into behavior can be difficult.”

DesJardins added that in his profession as a teacher and a writer, his thinking about ethical issues is, “always at the 30,000 foot level.” It is valuable to participate in a discussion with business executives since this gives him the opportunity “to really listen to the details and learn what’s really going on with some of these ethical issues.”



Joe DesJardins listens to the discussion

John McCall pointed out that one of the challenges for faculty teaching business ethics courses is that the message may get “ghettoized” in a particular course. “You are fighting a culture that faculty and other disciplines are actively pushing against the need for ethical discussions. In finance disciplines, the mantra is “shareholder value” but the means by which this end is maximized or promoted often is not part of the discussion. It’s just assumed that the market will take care of that.” He added that “what ethics means for me in my organization is to help the other faculty see that ethics is actually an integral part of any organization.”

McCall agreed with DesJardins that he hoped to get at some of the “details” in the course of the discussion. “I want to know more than ‘it’s complicated’. I want to know why it’s complicated and how it’s complicated and what implication that has for judgments you make about the propriety of behavior. It’s always in the details. Moral judgments have to be based on the facts of the case and the relevant differences between cases as well as the overarching moral principles. So I want to know the details, too.”



Norm Bowie acknowledged that he was not confident he really understood the financial services industry. "I'm going to sound like a very uneducated lay person. But actually that's the world you all are facing out there—people like me who don't understand the industry." He also wasn't certain about the distinction between life insurance and the financial services industry. "If you look through the chapters on the financial services in business ethics books, you never read anything about life insurance. This is good news—you guys are not controversial!"

He hoped that during the course of today's discussion that he would learn more about the financial services industry. "Maybe I will finally learn something about this industry so I can talk intelligently about it."

Tony Garcia believed that spending time thinking about ethics is one of the more important ways that executives can spend their time. "If I am going to spend a day in my life I would rather do something that I have a passion about, something that I would like to get better at."

Jayne Schiff observed that she brought a different perspective since she works as producer rather than as an executive. When she started in the business she quickly realized that, as a woman, it was necessary for her to do something to distinguish herself in the industry. She decided to earn her CLU, a designation from The American College. "The more courses I took, the more I realized how valuable the CLU was to me. It was more than just the courses. It really meant something to me, it gave me that little edge."

Schiff continued that the credo of every designee of The American College requires the agent to treat their clients in the way they would want to be treated. "I truly believe that. I can't sell you something if I don't believe in it. That is a part of my ethic. I can't sell it just because it is the newest, the best, the greatest. I may take a little longer to deal with a client, but that is what I believe is right."

In terms of what she hoped to get out of her participation today, she noted that, "there are a lot of times I have issues with ethical behavior in my own industry. It can keep me up at night thinking about what's right and what's wrong. I am looking forward to hearing how other people handle their ethical concerns."

Ken Goodpaster echoed his academic colleagues about the importance of culture in the business education establishment. "One of the things about the culture of business schools is that an ethics professor may carry chalk, but other colleagues carry erasers. And it would be a nice thing if the erasures weren't so vigorous."

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Otherwise, the student gets a very strange take away from business school, which is there is this ‘soft stuff’ over here, and then there is the ‘serious stuff’ over there. And when push comes to shove, the serious drives out the soft.”

He shared that they were trying to make ethics a priority in business education at the University of St. Thomas. “I think we have achieved an extraordinary penetration of the culture at this institution. There are very few ‘erasers’. I’m not naïve enough to think there are none, but there are very few. And it’s exciting to have the largest ethics faculty in a business school in the world and to have colleagues who are constantly talking about ethical issues and how they connect to each aspect of business.”

Goodpaster hoped to watch business leaders become “philosophical”. He explained what he meant by becoming “philosophical”. “It means that somehow one needs to step outside of the exigencies of this company’s bottom line and look at the common good. Sometimes executives don’t think they are philosophical, sometimes they think they don’t know how to go to 30,000 feet, but they do, they do it a lot. And I like to listen to the way they do philosophize and encourage it.”

Bud Schiff shared that when he first began in the insurance industry he knew that the foundation of the business was trust. “The industry did a very good job, I think, of creating trust among the public.” But he believes that the perception of the financial services industry has changed and that the industry has lost the trust of the public. “The perception of the financial services industry is primarily hedge funds, private equity funds, derivative arrangements, investment banks. It’s not a proud image.”

Schiff added that he only hires those individuals who know that what we do is all about maintaining the trust of each constituency they serve. “The one thing they have to recognize is that our foundation as a consulting firm is based on trust.” He added he would not tolerate “anything that doesn’t lead to the highest levels of integrity when we deal with any of our constituencies. I think we have come a long way and done a really good job of building that trust.” He hoped that the day would generate “some great dialogue and interesting conversation.”

Pat Werhane shared that the focus at DePaul University is helping students who wouldn’t have normally gone to college. “90% of our students are on scholarship and the first in their family to go to college. We have a real focus on poverty and as a result of that my institute has been working on public/



private partnerships to help poverty alleviation.” She shared that “putting theory into practice with these initiatives has just given me a whole new life to think about these issues.”

Today, she hoped to learn from the group, “how to create an ethical culture. What do you do with an organization that lacks an ethical culture? Do you have to give up or are there ways that you can actually turn it around? And companies that have a great culture, how do you keep that going? It’s so easy to become complacent. We have all done that. That’s my challenge.”

Julie Ragatz said it was a privilege to work with the members and supporters of the Center for Ethics in Financial Services. “Each of these people is genuinely committed to the mission of the Center, which is to raise the level of ethical behavior in the industry. I continue to be amazed at the amount of dedication, loyalty and commitment people have to this business and the services it provides to the American people”.

She believes that the mission of the Mitchell Forum is important. “What Jim and Ron have created here is a kind of break in the loop where executives and academics can spend a day thinking together and learning from each other. This is a wonderful opportunity, and I am glad to be a part of it.”



Peter Tedone makes a point during the discussion



CASE STUDY: PERVERSE INCENTIVES

THE SITUATION

BASEL ACCORDS

The Basel Accords are “a set of agreements by the Basel Committee on Bank Supervision which provides recommendations on banking regulations in regards to capital risk, market risk and operational risk. The purpose of the accords is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses.”¹ These agreements are enforced by law in the United States, Canada, Japan and the major European countries.

Basel Accord I was issued in 1988 and focuses on credit risk. Assets of commercial banks were classified and grouped in four categories according to credit risk.

THE CATEGORIES WERE:

Claims on OECD governments and central banks, such as US Treasury bonds	Zero risk weight. These assets required no capital
Claims on other OECD public sector entities (such as U.S. state and municipal governments, Freddie Mac and Fannie Mae)	20% risk weight. These assets required 1.6% capital
All residential mortgages, regardless of risk characteristics	50% risk weight. Mortgages required 4% capital
All other assets, including corporate bonds and equities and ordinary commercial loans	100% risk weight. These assets required 8% capital

Banks that operate internationally are required to hold capital equal to 8% of risk-weighted assets.

So, for example, if a US commercial bank holds a \$1,000 municipal bond, it must back that with capital equal to \$16 (20% of 8% of the \$1,000).

BASEL COMMITTEE'S REVISED CAPITAL ACCORD

In response to comments from the banking industry, the Basel committee revised previous capital requirements. This action reflected their beliefs that (1) the “risk buckets” were too stringent and (2) banks had developed sufficient control mechanisms to better manage their risk portfolios. Regulators

¹Access at [http://investopedia.com/terms/b/basil accord.asp](http://investopedia.com/terms/b/basil%20accord.asp)



were thinking that the original Basel rules were keeping banks from expanding their holdings of mortgage assets, which regulators viewed as relatively safe.²

A key modification took effect on January 1, 2002 which broadened the definition of low-risk securities to include securities rated AA or higher by the recognized rating agencies. These low-risk securities now had a 20% risk weight (1.6% capital requirement). This modification came to be known as the “Recourse Rule.”

“[The Recourse Rule] meant that commercial banks could issue mortgages—regardless of how sound the borrowers were—sell them to investment banks to be securitized, and buy them back as part of a mortgage-backed security, in the process freeing up 60 % of the capital [1.6% of assets rather than 4% of assets] they would have had to hold against individual mortgages. Capital held by a bank is capital not lent out at interest; by reducing their capital holdings, banks could increase their profitability.”³

According to Kling,⁴ the 2002 rule had several harmful effects:

- Created opportunities for commercial banks to lower their ratio of capital to assets.
- Created the incentive for ratings agencies to provide overly optimistic assessment of risk in mortgage pools.

Change in the competitive environment adversely affected Freddie Mac and Fannie Mae. They responded by aggressively lowering their own credit standards in order to maintain a presence in the market and meet their affordable housing goals.

“Thus, the 2002 rule unleashed the final stages of the mortgage boom: the expansion in private label securities and subprime lending.”⁵

The commercial banks were able to substantially reduce their regulatory measures of risk with little or no corresponding reduction in their overall economic risk. That helped them to mask the deterioration in their true financial condition.

²Kling, Arnold “Not What They Had in Mind: A History of Policies that Produced the Financial Crisis of 2008”. September 2009. <http://ssrn.com/abstract=1474430>

³Friedman, Jeffrey. “Three Myths about the Crisis: Bonuses, Irrationality and Capitalism” Weblog. *Causes of the Crisis*. 9/14/09

⁴Ibid.

⁵Ibid.



THE CASE

Steve walked into the lobby and wasn't surprised to find John waiting for him. They had gotten their MBAs together from Columbia years ago. They had stayed friends through the years, even though today they were both senior executives at large, competing commercial banks. Steve figured John would want to talk to him after he had heard Jeffrey Friedman, the keynote speaker at the national conference they were both attending.

"So what did you think?" John asked as he steered Steve away from the crowds and to a table in the corner of the room. "I told you Jeffrey Friedman was a real catch for the conference organizers. But I suppose I'm not surprised he decided to come. I think he is trying to get the word out."

Steve smiled a little. John certainly was on fire about this guy, "You know, John. I am not sure that I'm buying it."

John look surprised. "What do you mean? It seems pretty obvious to me. The fact is that the regulators created some very powerful incentives for commercial banks like ours to get into mortgage backed securities in a big way."

"Let's stop here a second," Steve responded. "You're talking about the Recourse Rule. The Recourse Rule was designed to be market-friendly, since it made it possible to reserve less capital if banks transformed individual mortgages into mortgage-backed securities."

"That's what Friedman is talking about!" John was really excited now. "Commercial banks like ours were getting pressure from Washington to increase our mortgage loans to people with low and moderate incomes. The Recourse Rule meant that commercial banks like ours could issue lots more mortgages to lower income people, because we were able to sell them to the investment banks to be securitized. With an investment grade rating on these securities from the rating agencies, we could buy the mortgages back as part of a mortgage-backed security. In the process, we could free up 60 % of the capital [1.6% of assets rather than 4% of assets] we would have had to hold against the individual mortgages. You know well, Steve, that capital held by a bank is capital not lent out at interest. By reducing our capital holdings, we could increase our profitability. Our management felt that we had an obligation to our shareholders to take advantage of the situation."



"But," Steve reminded him, "not everyone did. JP Morgan Chase didn't and our bank didn't. We talked about this at our bank over and over again. We were concerned about the quality of the underlying mortgages, and just weren't convinced that most mortgage-backed securities deserved the investment grade ratings they got."

"It's not like we didn't talk about the possible risks at our bank, too," said John. "But if the regulations make it possible for you to make more profit by reserving less, then I don't see how you would go to your shareholders and say 'You know, we just can't do that.' Friedman's point is that the regulations made it more difficult for companies to act in their long-term interest. You've got to agree with that at least. That makes the case for less regulation, not more."

"I'm not sure I do agree," Steve said thoughtfully. "The assumption behind the Recourse Rule was that risk management is better handled by the private sector than by government regulation, and that the commercial banks were getting increasingly good at it. If you look at the language of the rule, it says pretty clearly that the expectation is 'banking organizations should be able to measure and manage their risk exposure from the risk positions they are taking.' I'm not trying to be a Monday morning quarterback," he smiled at his friend. "But it doesn't seem like most of you guys did a very good job with your risk management, does it?"

"But here's the thing, Steve. In relatively free markets, companies can pursue different risk strategies. Ultimately, the wiser and better strategies will prevail. The problem is that when the government intervenes like it did with the Recourse Rule, it tips the deck. Most of the commercial banks were taking a lot more risk with less capital than your bank or JP Morgan Chase. If you reward people for acting in a certain way, you can't expect them to do anything else. That's why the entire system almost fell apart. Of course, the irony is that this is something that more regulation won't fix."

"John, I think that you and Friedman are placing way too much emphasis on the coercive power of regulations. The bottom line is that we all get paid to determine what levels of risk and capital are appropriate. Even if the regulations say we only have to reserve 4%, if we think that we need to reserve more to protect ourselves and our customers, then it's our fiduciary duty to reserve more. You still haven't convinced me that things would have been better with less regulation. Without reserve requirements in place, wouldn't there be pressure to lower your reserves to the level set by your most aggressive competitor?"



"I see your point, Steve. And I am not talking about no regulation whatsoever. But I still believe Friedman has a point. Whether most of the commercial banks should have resisted the incentives is one question. But at the end of the day, the government shouldn't make it harder for you to do the right thing and then, when you predictably act just as they suggest, publicly blame you for it. What was the article we read in grad school about this?"

"The folly of rewarding A when hoping for B," Steve responded. "No, you're certainly right about that—the government's attempts to help usually aren't very helpful."

QUESTIONS FOR DISCUSSION

1. John's argument is that the government incentives created by the amendment of the Basel Accords in 2002 incentivized investment banks to take risks which turned out not to be in the long-term interests of their company or their shareholders. Do you agree with John's argument?
2. The amendment to the Basel Accords was developed in response to concerns that the "risk buckets" were too stringent and therefore did not allow sufficient flexibility to bank executives who had access to savvy and sophisticated risk measurement tools. To what extent should government regulators respond to concerns from the community which they regulate?
3. The dilemma posed by the Resource Rule can be understood as a dilemma between the short-term and long-term interests of the institutions involved. While it may be in the short-term interest of the institution to reduce the percentage of their capital reserve, it is in the longer-term interest of the institution to effectively manage their level of risk exposure. Is this example a manifestation of a larger problem in the financial services industry regarding how to balance short versus long-term interests? Why or why not?
4. As stated in the case, investment banks responded in different ways to the change in the rules. Were risk management processes at banks less sophisticated than regulators thought? Or did management ignore the recommendations of their risk managers? Or something else? Do you believe that there was anything about the corporate culture at these firms which motivated their responses?



5. "In public interest theories of regulation, the government intervenes in the market in order to maximize social welfare; he behaves like a benevolent and omniscient dictator acting on behalf of society as a whole."⁶ To what extent does regulation succeed in promoting social welfare?
6. What should be the objectives of regulation within the financial services industry?
7. Regulation, it is argued, is necessary to check what would be unethical behavior if people were not regulated. Do you think it is true that we need government regulation to keep us from acting unethically?
8. In an editorial in *The Wall Street Journal*, Thomas Frank argues, "It was not merely structural problems that led certain regulators to nap through the crisis. The people who filled regulatory jobs in the past administration were asleep at the switch because they were supposed to be. . . The reason for that is simple: There are powerful institutions that do not like being regulated. Regulation sometimes cuts into their profits and interferes with their business. So they have used the political process to sabotage, redirect, defund, undo or hijack the regulatory state since the regulatory state was first invented."⁷ Do you agree with Frank's argument? Why or why not?
9. The theory of regulatory capture attempts to explain how powerful industries work to co-opt regulators, who are often relatively resource-deficient, into promulgating regulations that promote their own interests, rather than the interests of society as a whole. Stephen Davidoff in *The New York Times* argues that a new form of regulatory capture partially explains the financial crisis, which he refers to as ideological and social capture of regulators. "Among these people, there is no evil or nefarious plot to regulate in favor of the banks. These men and women may believe they are doing their best, but their worldview is affected by the people they interact with. This is a problem that can be exacerbated by a revolving door between finance and regulators."⁸ Do you agree with Davidoff's argument? Why or why not?

⁶Boehm, Frédéric "Regulatory Capture Revisited—Lessons from the Economics of Corruption" Working Paper. Internet Center for Corruption Research. July 2007. <http://www.icgg.org/downloads/Boehm%20-%20Regulatory%20Capture%20Revisited.pdf>

⁷Frank, Thomas. "Obama and 'Regulatory Capture'" *The Wall Street Journal*. June 24, 2009. Web. 11/22/2010

⁸Davidoff, Steven. "The Government's Elite and Regulatory Capture" *The New York Times*. June 11, 2009. Web. 11/22/2010



10. Are the perverse results of systems an ethical issue? Are systems that create moral hazards and perverse incentives unethical? In short, are there systemic or organizational ethical issues?

11. The Recourse Rule is only one example of government regulations creating perverse incentives or moral hazards. Can you think of any examples from your own company where regulations caused you to move in a direction you thought was not prudent or even unethical? If so, what did you do in such a case?

12. Is following the Recourse Rule a case of being diligent in the pursuit of profit? To what extent is performing in such a way as to maximize profit a fiduciary responsibility of a CEO of a publicly held company?

13. Are people too busy doing compliance to do ethics?

14. It has been argued that AIG's insurance arm survived the market meltdown because of state guarantee funds. Isn't it probable that if Credit Default Swaps had been treated like re-insurance, different reserve rules would have been in place and AIG might not have been as vulnerable?

15. What are the effects of government violating bankruptcy protocol in the GM takeover?



Julie Ragatz and Jim Mitchell listen to Ron Duska



Bud Schiff listens as Ken Goodpaster makes an argument

THE ROLE OF THE RECOURSE RULE IN THE MORTGAGE CRISIS

Ron Duska introduced the case by saying that he was interested in the phenomenon of “perverse incentives”. He summarized the ethical issue the case posed: “What it amounts to is that the recourse rule put the banks in a position of almost having to loan out money for subprime mortgages.”

Pat Werhane disagreed. “That just says that I’m a complier and here is some rule that I’m going to comply with rather than stepping back and thinking about the implications for my bank and my customers and my long-term interest. We are letting banks off the hook by blaming the regulations.”

John McCall agreed with Werhane. “If you look at the ‘John’ character in the case, I think he represents an insulting view of management. Because it suggests that they have no discretion. It’s saying that they must seize the incentive. And obviously that’s false since some did not. This just feeds into the idea that all you have to do is maximize short-term share value.”

Jim Mitchell said that he “wanted to push back a bit”. “Banks were under serious pressure from both political parties to make loans to lower-income borrowers. So, because I am practically forced to, I am going to make subprime mortgages. My choice is that I can make these mortgages in a way where I have to put up 4% capital against them or I can do it in a way that I only have to put up 1.6%. I might as well do it in the way that requires less capital.” Mitchell felt that changing the recourse rule was one of the causes of the mortgage crisis since,



“I think it is inappropriate to focus exclusively on regulation and not focus on the culture of the company, not focus on inappropriate choices by firms. I think there are all kinds of things that went wrong.”

John McCall

except for this change, banks would have been required to hold more capital and been less at risk of illiquidity.

McCall cautioned against putting too much emphasis on the regulatory aspect of the crisis. “It’s the ‘but for’ rule. The ‘but for’ rule could apply to any number of aspects of the context in which this occurred. You could pick any one of those and say it is the cause, but you would be mistaken. It’s all of these things together that created the problem. I think it is inappropriate to focus exclusively on regulation and not focus on the culture of the company, not focus on inappropriate choices by firms. I think there are all kinds of things that went wrong.”

ARE ALL DECISIONS ETHICAL DECISIONS?

Tony Garcia wasn’t sure this case was about bad ethics. “You also need a talent base with strong intellectual capabilities in addition to sound ethical judgment. I believe that sound business strategy, strong leadership and a basic moral compass can navigate any bad situation. I think that we need to take into account that there were some very ethical people, who failed at not understanding risk management and created significant issues for their companies.”



Norm Bowie appreciates John McCall’s point

Jayne Schiff wasn’t confident you could make a sharp distinction between risk management practices and ethics. “I think risk management has a lot to do with your ethics.”

Peter Tedone agreed with Garcia. “Not every decision is an ethical dilemma.

Some decisions are strictly business. If a company has a certain risk tolerance and makes a decision that is outside of that tolerance, is this an ethical problem or a competency problem?”

McCall thought that there was an important distinction between poor business decisions that were also unethical and choices that were simply poor business decisions. “I don’t think it was unethical for Congress to heavily promote, which I agree that they did, the idea of home ownership by lower



economic levels. It may not have been the right thing to do, but it was not unethical. But, on the other hand, it was unethical for companies to go to the ratings agencies and buy a AAA rating knowing that the investing public and institutions purchased securities on the strength of these ratings.”

THE ROLE OF SECURITIZATION

Ken Goodpaster wondered about the implications of securitization. “It seems that securitization has led to an ‘anonymizing’ of the mortgage loans. Bankers have lost track of the family that took out this mortgage. This has moral implications since the flesh and blood gets taken out of it, and it becomes more of a game, a maximization game. What does this dictate for future behavior?”

Mitchell believed that Goodpaster’s point was central. “I think that if you get away from a sense of who your customer is, it does just become a big game. At American Express, we had four values. Number one was that the customer comes first. That doesn’t mean that you do everything that the customer wants, because if you did that you wouldn’t be in business very long. But you do put them first. And if you put them first, you always maintain a sense of who they are.”

Bud Schiff agreed that the incentive to securitize did play a role in the subprime crisis. “But to take it one step further, there was the role AIG played. AIG made companies feel more confident since then they could essentially ‘insure’ the subprime loans. Of course, they didn’t actually want to use the word ‘insurance’ since if they called it insurance, they would be subject to insurance regulations and standards.”

Tedone wanted to talk about consumer responsibility. “While we are talking about regulating and being sure that companies behave appropriately, doesn’t this really beg the question? Is there not some obligation on the part of the consumer?”

THE ROLE OF REGULATION

Norm Bowie argued that it was impossible for capitalism to work in the absence of any regulation. “Someone made the distinction between the general broad principles and rules. There is a difference in the accounting systems in the United States and Europe. In Europe, they have a system based on broad principles, whereas here we have very detailed rules. Is the issue what kind of regulation we should have?”

Mitchell referred to the questions that accompanied the case study. “Maybe



“We have for at least a couple of decades in this country equated better disclosure as being more disclosure....What we need is ‘meaningful disclosure’—disclosure that helps consumers understand the product they are buying.”

Jim Mitchell

before we discuss the form regulation should take, we need to consider Question #6 which asks, ‘what should be the objectives of regulation within financial services?’”

Garcia believed that regulation of financial services should have two objectives. “I think that consumer protection should be number one. That is what the state regulators and attorneys general should focus their efforts on. The second objective is financial solvency. You can’t solve bad management, but you should have a guide post to mitigate the risks by establishing transparency around financial solvency requirements.”

McCall thought it was possible to apply an ethical distinction to Garcia’s comments. “One way to talk about ethics is to talk about the common good. And I think we can’t lose track of that. I think that goes to the solvency question. If we are talking about a system which is subject to failure, it is not only the individual players in the transaction that are harmed, but it’s the society as a whole.”

Tedone was concerned about confusing ethical behavior with regulatory compliance. “I think that it is problematic to assume that regulations inherently promote ethical behavior, especially in the financial services industry. Regulators are a fact of life that I have to deal with. They have great influence over what my company does, and yet often the outcomes they produce are poor, not necessarily for me, but for many components of the industry. That’s why I wince when we talk about the need for more and better regulation.”

Joe DesJardins challenged some of the assumptions that the group was making regarding regulation. “We started with this implicit model of regulation in which the government comes in and sets rules to restrict self-interested behavior. But why were the regulations mentioned in the case changed? They weren’t changed because somebody had some altruistic view of serving the underprivileged. They were changed by people in power, or people who had connections to people in power, who wanted to make more of a profit by lowering their capital requirements.”

Bud Schiff worried that regulation has become too broad and therefore, not only too onerous, but also ineffective. “My idea is that regulation should be surgical in nature. It ought to be something that’s understandable by the people that are writing it and by the people who have to abide by it.”



Goodpaster was interested in exploring the metaphor of “surgical intervention.” “I loved your metaphor of regulation as a kind of surgery. Let’s follow this out a bit. We don’t let just anybody do surgery. Most of us want to know that the person who is doing the surgery is *qualified* in some way to do it. Therefore, we have credentials to allow only surgeons into operating rooms. Is there any analog to this in the financial services industry, or is this idea just unrealistic?”

Werhane mentioned that one of the problems with regulation is that it is often written by regulators who have a “revolving door” with the industry that they regulate. “There is a lot of data on the back and forth between business and government. Some of these regulators are motivated by self-interest when they think of where they are going to be in the future.”

Bud Schiff thought that lobbyists could play an important and constructive role. “Regulators should have a basis of knowledge, but they need lobbyists to help them work their way through the issues. And here is where ethics really comes into play. Because when you are looking for help to write the regulation, the regulator shouldn’t be thinking, ‘where is my next job going to come from?’”

Mitchell raised the issue that regulation often, incorrectly, focuses on more disclosure as a way to protect the consumer interest. “We have for at least a couple decades in this country equated better disclosure as being more disclosure. But more is not always better. What we need is ‘meaningful disclosure’—disclosure that helps consumers understand the product they are buying.”

THE ROLES AND RESPONSIBILITIES OF CORPORATE BOARDS OF DIRECTORS

Julie Ragatz wondered about the responsibility of corporate Boards of Directors. “I think that there was a real absence of leadership at certain companies involved in the financial crisis. How do we address this issue?”

Bud Schiff believed that there are two key responsibilities of a corporate Board of Directors. “Number one is to look out for the interests of, and create value for, the long-term, rather than the short-term, shareholders. The second is to focus on the long-term interests of the organization. I think that if a Board meets these criteria, the company is in good hands.”

Mitchell agreed and, referring to his experience serving on corporate Boards of Directors, added, “As a Director, I am legally responsible for looking after the interests of the shareholders. But I get to define over what period of time I want



“We also discovered that compensation doesn’t mean that you are really good. There are a lot of overpaid CEOs, and they were overpaid because they did not perform.”

Pat Werhane

to do that. It is not my job to help maximize the next quarter’s earnings. It is my job to maximize shareholder value over the long term.”

Bud Schiff suggested that there had been a change in the way in which Directors perceived their responsibilities in recent years. “I think what happened with Grasso and the New York Stock Exchange really forced Boards of Directors to start paying attention. You couldn’t have had a more prestigious Board of CEOs than the Board of the New York Stock Exchange. When they terminated Grasso and discovered that he was entitled to a severance package of around \$240 million, it was very embarrassing. They looked like deer in the headlights of a car. How could you fire a guy for incompetence and then pay him \$240 million dollars to go away?”

DesJardins wondered what was driving this new awareness and engagement on the part of the Board of Directors. “Is it coming from an increased self-awareness or is it market-driven?”

Garcia thought that it had something to do with the reputation of the Directors. “Do you want to be on the Board that paid Grasso \$240 million to walk away, or do you want to be on the Board that does it right?”

McCall believed that a broader societal change has driven some of the changes in the corporate boardroom. “Markets always operate in the context of cultural norms, and expectations for compensation are set within those cultural norms. I think that with public pressure these norms have begun to shift a little.”

Werhane said that part of the problem is that poorly performing executives were being overpaid. “We also discovered that compensation doesn’t mean that you are really good. There are a lot of overpaid CEOs, and they were overpaid because they did not perform. I think that people are taking the link between compensation and performance a lot more seriously.”

Jayne Schiff noted that the link between performance and compensation was one of the strengths of the commission-based model for sales people. “People often complain about the commission model, but in this model your pay is truly based on your performance. If you don’t perform, you don’t get paid. Maybe there is something to be said for that.”





THE PRACTITIONERS' ETHICAL DILEMMAS

EXECUTIVE DILEMMA #1

The company was originally formed as a stock holder-owned company in the 1960s with the charge to sell dividend-paying insurance. At the time, several individuals put up some capital, up to the statutory required level. The company continued to sell only dividend-paying policies. By 1996 the Board of Directors of this company faced a big dilemma. The Board was considering a new direction for the firm that would likely require a capital infusion. They wanted to have the following question answered: Do the shareholders who provided the original regulatory capital own the firm? And, therefore, if they put in more capital and more surplus was generated do they own that? Or is the firm owned by its participating policyholders?

It's a very reasonable question. The CEO at the time really believed in the mutual model. The CEO engineered an "independent legal opinion" from outside counsel that concluded that participating policyholders were entitled to a portion of the surplus. Therefore, in any sale of the company, the surplus would have to be distributed to the policyholders. The Number Two executive at the time knew that the "independent legal opinion" was flawed and was convinced that the CEO had bullied the attorney to write it the way he wanted it. The Number Two believed the shareholders who had their capital at risk should be rewarded with any gains. The policyholders should be entitled to the benefits of a stable dividend scale, but by charter and state law they had no role in the company's corporate governance. The Number Two presented his counterargument to the CEO and was completely rebuffed.



The participants listen as Bud Schiff makes a point



The dilemma was that the CEO essentially buffaloed the Board of Directors. Should the Number Two just sit back and do nothing or bring it up to the Board of Directors? As Number Two, you usually don't go to the Board, even if you disagree with the CEO. In this case, the Number Two talked to the independent Chairman of the Board and presented the case to him as best as he could. The Chairman counseled the Number Two that, if he was able to get the CEO position, then he could do it the right way and go forward with the growth strategy. And, in fact, that is what happened.

Jim Mitchell noted that the organizational structure created an opportunity for this executive to share his concerns. "You are fortunate that you had someone to talk to about your concerns. Many companies do not separate the CEO and Chairman positions. This case illustrates one possible reason to separate them."



Joe DesJardins contributes to the discussion

John McCall wondered whether a compromise would have been possible. "The question about how to allocate rights to the value of the firm among the various stakeholders arises for many firms. Did it have to be a question of all or nothing? That the surplus should go either to the shareholders or the policyholders? I think you can make an argument that an allocation should take both constituencies into account."

EXECUTIVE DILEMMA #2

I received a request to fund a sporting event that some of the senior executives were participating in on a personal basis. I was asked to get the funds from a partner company whose products we marketed. I first heard about this when I was at a recent awards ceremony and my boss said, 'He'll fund it this year,' referring to me. I just filed that and didn't say a word. And sure enough, I get this request from someone in my firm that they would like us to reach out to our business partner and ask for about \$25,000. I called my CFO and told him, 'You should know that I am getting this request, and that I am not going to approve it, and that may cause some problems, politically'. I sent out a message explaining that since we don't have much of a market presence in the location



of the sporting event, this is not the best use of our resources, especially for the entertainment pleasure of a group of already highly compensated executives.


Developmentally for me this was a wonderful opportunity to figure out who I was going to be in this organization. Are you going to “go with the flow and be a team player” or are you going to stand alone for doing the right thing and take the pressure that goes with that position? No one overrode me on the decision because I think that they knew I would stand firm. At that point I had been with the company three and a half years, and I had a rich history of just saying “no” to the business as usual things that I believed to be fundamentally wrong. Upon reflection, I should’ve done more due diligence on the company before I accepted that role. That was one of the bigger lessons I carried away from the experience. Most people just drink the Kool-Aid. If you get a bunch of people and really overpay them, most of them will do whatever you tell them to do. I was lucky that I had been with companies before that had done it the right way. And they were successful doing it the right way. Pretty soon I decided I didn’t want to be affiliated with a company doing it the wrong way any longer and began to search for a different opportunity.

Jim Mitchell agreed that most people will just drink the Kool-Aid. This executive must have been delivering great results or the culture would have found a way to get rid of him before he quit. Jim thought that is part of why leading organizational change is so difficult. “One of my theories is that you can’t get too far out in front of the culture of the organization. If you get too far out in front, the rest of the group will cut you off and find ways to get rid of you. You have to consolidate your power base as you go along.”

Peter Tedone believed that you need to rely on the good people in the organization to help make needed changes. “There are always some people that are uncomfortable with the unethical culture that you could rely on to give you good information.”

Ken Goodpaster believed that this case was really about moral courage. “Listening to this as an educator, I’m struck by the distinction between *knowing* right from wrong and actually *doing* the right thing. This sounded to me like a story about having moral *courage*, which is different from having moral *intelligence*. And they don’t always go together.”

Tony Garcia said that it was important to remember that people are always watching to see what the leader is going to do. “It’s all in the little things. Every



decision you make positions you and your team in a certain way. It is the little things that we let go by that turn into bigger problems down the road.”

EXECUTIVE DILEMMA #3

Our firm is a consulting firm in the executive benefits compensation area. This particular case was brought to us by a broker with whom we had written a number of cases before. The client was a publicly owned company whose primary business was to support the auto industry.

My team had been working with the client for about a year to develop a deferred compensation plan. The person who was quarterbacking this from the company's perspective was the head of Human Resources. For the final meeting we were going to go through all of the paper work, and the HR person had the authority to sign off on all the documents.

When I haven't been directly involved in the process from the beginning, I like to try and get some background about the company. When I looked at the financial statements, I wasn't comfortable with the trends that I saw. They were still a strong and solid company, but they had lost a couple of significant contracts with the auto industry. That was through no fault of their own, but it was in 2006 that the problems with the auto industry were just starting to surface.

The bottom line is that I wasn't certain that the deferred compensation proposal was the right move for the company at this time. My dilemma was whether I should share these concerns with the head of Human Resources. If I do, and the company decides not to go ahead with the plan, there are going to be a lot of people who are not going to be very happy. Moreover, the HR person might not be receptive, given that she had her team working on this for over a year and had already gotten buy-in from her firm to go ahead. Finally, my own team had invested a lot of resources into putting this package together and, since we work on a contingency basis, we don't receive any compensation until the deal actually gets done.

On the other hand, if the company did go through with this package and then got into financial difficulty, there could be a lot of people who might get hurt. The company and the executives who invested their money in the plan would now have dollars at risk. From the broker's standpoint, there would be a "charge back" on the commissions he earned from the sale, and the insurance carrier would suffer a financial loss, as well.



I agonized over this for several days. It really kept me up at night thinking about what was the right thing to do. When we went out for the meeting, I pulled the broker aside and I told him that I thought there were some issues with the company, and I was going to recommend that the company defer the decision for a year. I had a long conversation with the HR representative, a real heart-to-heart talk. While her initial response was that the company was healthy, I presented the reasons I believed it was a good idea to defer, given what I was seeing in the financial statements. In the end, she agreed with my analysis, and they decided not to go ahead.

In retrospect this turned out to be the absolutely right decision since in 2008 this company filed for Chapter 11 bankruptcy. There are two interesting developments from this case. First, the HR head was laid off as a result of downsizing due to the company's financial troubles. She was a strong leader and was hired by another



Tony Garcia, Jayne Schiff and Bud Schiff listen to Ken Goodpaster

firm and, as soon as she started that new position, she called my organization to do some work with her company. She felt good about our interactions and a real trust had developed there. A second benefit is that now when my staff are analyzing plans and programs, they do a much more thorough job looking at the trends and the background before we make a decision to go ahead.

The issue was that everything looked right legally. There would have been total justification to go ahead. It was a gut feeling about what I saw in the financial statements that suggested we hold back. It did work out okay, but it may not have.

Tony Garcia pointed out that the sort of intuition demonstrated in this case is developed through experience. "The decision-maker had a high level of



“I think it is the level of experience and competence that tells you, ‘I need to get more facts on this situation before I can make a decision’.”

Ron Duska

competency. But if someone faces this issue earlier in their career and does not have that level of experience, they probably would have gone ahead with the case.”

Ken Goodpaster believed the case raised the question of when to trust your intuition. “Some of our convictions are more trustworthy than others. How does a person discern the difference between a ‘fake’ intuition (e.g., indigestion) and a reliable enough intuition to make a decision like the one you made? As decision-makers, we all have to face up to the question of whether this is indigestion or insight.”

Ron Duska focused on the importance of knowing when you need more information. “When I am doing ethical sensitivity exercises with my students, one of the most important things we focus on is getting enough of the facts. I think it is the level of experience and competence that tells you, ‘I need to get more facts on this situation before I can make a decision’.”

Joe DesJardins wondered whether intuition could be taught. “Part of what’s interesting here is that you picked up something that was missed by everyone else. If the trends were there, why didn’t anyone else see them? How can we train people to do what you did?”

Peter Tedone didn’t think you could teach intuition, but that you could turn this experience into a teachable moment. “I’m sure those guys came back to the office and talked about what happened. And the take-away is that they walked away from a pretty lucrative deal because the boss

thought it was the right thing to do. That’s leadership and ethics right there.”



Jayne Schiff listens to Tony Garcia's ethical dilemma

EXECUTIVE DILEMMA #4

My ethical dilemma arose soon after I went to work for a new company selling large group cases. Even though I worked with large corporations in my previous positions, this was something new for me since I was working on benefits cases. One of my new client companies had about 1300 employees, who were located all over the country. The client did a great job with their employees, and they offered very generous benefit programs.



We got a renewal on their health plan and the renewal represented a 39% rate increase. The average age of the employees was 37—it was a healthy and young company—so that was pretty troubling. Also, my firm had a large book of business with this company. They didn't just have a medical plan; they also had a life plan and a disability plan among others.

I discovered that my company had a couple of issues. The first was a focus on getting the deal done and moving on to the next client. The emphasis was not on "taking care of your clients". They wanted me just to go sell the 39% increase, but I thought we could do better for the client. I spent vacation time on this, and I would interrupt dinners to take calls from the client trying to work this out. My client appreciated the work, but my firm did not.

The other issue was that my firm was not willing to bend on the commission rate. With a group this size, the commission rate is usually negotiable. But my firm wanted a commission rate of 5%, and that was it. I was arguing with my own firm that we really needed to cut back to a 4% commission, which would be more palatable for everyone.

One of the things I learned from the experience was to be true to myself and to the client. We got the renewal of 39% down to 20%. I personally was there for the entire process, explaining to the employees how to identify their needs and how they should choose a plan. The client was happy, but my firm told me that I had spent too much time on this case. That didn't feel right to me, and I did not stay with this firm much longer.

Norm Bowie wondered what problem the firm would have with someone trying to make the client as happy as possible, "I can understand why your company would be unhappy to lower the commission, but if they were unhappy because you were looking out for the client, isn't that a little strange?"

Bud Schiff commented that it comes down a balancing act. "If the person is spending all of his or her time with one client, then he or she is not out there developing new client relationships. It is about production, and that is a reasonable concern on the part of the company."

Peter Tedone thought that the firm's approach to the client company was a poor business judgment. "The firm should have been very concerned about a major client having a 39% premium increase. Even if they knew they couldn't work the rates down, they should have made the client feel like they were working

Perspectives on Ethical Leadership



“Part of the problem now in business ethics is that the people and the companies we thought were ‘good guys’ turned out not to be good.....We need new stars.”

Norm Bowie

24 hours a day, seven days a week to try. The market will take care of a company like that; they won't survive.”

Bud Schiff thought that this case offered an example of the principle of fairness. “I try to convince the people in my business that fairness doesn't mean that we treat each client equally. Fairness means that we give the ‘hand-holding’ that is needed with each client. Each client gets what they need and some need more than others. It doesn't mean that you are necessarily taking away something from the other client.”

Jim Mitchell was struck by how many of the executives' cases focused on the balance between short term and long term. “I keep being struck by the short-term versus long-term trade-offs in these cases. So many seem to involve giving up something in the short term: giving up commissions on new business, giving up commissions that you could add on. A lot of times doing the right thing may be painful in the short term, but it will turn out to be the best thing in the long term.”



The participants listen as Ken Goodpaster makes a point



THE PHILOSOPHERS' QUESTIONS

ACADEMIC CASE #1

I have been thinking about our role as educators and what we are trying to do when we teach business ethics. In their business classes, students often get the message from our colleagues that what really matters is shareholder value. Students can come away with the idea that all you need to do is learn some really impressive technical skills, and you've got it made. If this is the message they are getting, then how do you get ethical and professional responsibilities institutionalized as a norm in the workplace?

Tony Garcia believed that while it is hard to transform an unethical culture, it is also difficult to shift the momentum of an ethical culture. "It comes down to ensuring that your talent management and recruitment process perpetuates your vision of ethics and character. If you are an unethical person working in an unethical environment, then you are going to attract unethical people. When I was being recruited by TIAA-CREF every interview focused on character; integrity; putting the needs of the client before the needs of the company."

Norm Bowie believed that stories like Garcia's interview are really important. "I think you need to tell those stories. Part of the problem now in business ethics is that the people and the companies we thought were 'good guys' turned out not to be good. Companies like Merck and Johnson & Johnson were really elevated for their ethics, but now their stars are tainted. We need new stars."

Garcia noted that ethical, values-based companies have a wonderful story to tell the marketplace. "Having a great reputation and building trust with your customer base will allow companies to create long-term value. While companies that have a headline and image risk issues must focus on defending themselves, the best companies have a wonderful growth opportunity in front of them."

John McCall thought there needed to be a basic shift in the training that goes on in business schools. "I think we have to change the way that finance is discussed. The assumption is that finance is 'all about numbers' and that makes it a 'hard science'. Since ethics is messy and about values, it is a 'soft science'.



John McCall participates in the dialogue



But if you look at something like 'net present value', we need to ask how do you come to that judgment? What assumptions are you making? There is a false distinction here between objectivity and subjectivity, between the hard and soft sciences."

Jayne Schiff believed that business classes often missed the opportunity to talk about ethics. "When I was in college, I took a labor relations class and we had a class project in which the class was divided into two groups; one group was assigned to represent management and the other group was assigned to represent the labor union. But the teacher did not talk about how the decisions we were making had ethical implications."

Ken Goodpaster thought it was important to remember that business ethics education is not limited to the classroom. "Ethics education also occurs in other places, such as industry associations, corporate training programs and forums like this one. They may be less formal or institutionalized, but they can be very real and very effective because they are peer-to-peer forms of education."

ACADEMIC CASE #2

I think that the ultimate justification for the financial system is that it functions as a mechanism for allocating capital so that the economy will produce goods and services that are valuable to society. My question is whether there is a way we can clearly distinguish between those financial instruments that add social value and those that do not. I understand the need to hedge. I worked in Iowa for a couple of years, and I know that farmers hedge to protect against risk, but at what point does the use of these instruments represent nothing more than a gamble at the casino?



Joe DesJardins and John McCall listen to Norm Bowie



Tony Garcia believed that, if you talked to financial engineers, “they could absolutely give you a reason why we need hedging instruments, how they help grow the economy and how they help to eliminate risk. But most things in the hands of an unethical person have the tendency to go awry.”

Bud Schiff agreed with Garcia. “I’m trying to think if there are any financial instruments that are just poor in themselves. It’s the way they get used. The instruments are there, and they aren’t inherently good or bad.”

John McCall brought up the question of Stranger-Owned Life Insurance (STOLI). “What do we think about life insurance policies that are owned by someone else?”



Peter Tedone listens to the discussion

Peter Tedone believed that STOLI was an example of a good concept taken to a bad extreme. “The original idea was a viatical settlement, which would let a seriously ill person pay his medical bills with an advance against his life insurance proceeds. With STOLI, though, you actually have policies that are initiated by investors who have no insurable interest in a person’s life. They are simply using life insurance as an investment.”

Jim Mitchell was concerned that many of our smartest college age students seemed to be interested in going into finance because of the perception that this is where the biggest money is. “It is one thing when our really smart kids want to become doctors or engineers. I think those activities have real value to society. But an investment banker doing mergers and acquisitions does not add much social value, in my opinion. They will tell you why you should do an acquisition and three years later they will tell you why you should sell it. And they make money both coming and going. I really believe that in America our best and brightest are not doing enough work that creates real value anymore. It can’t be a good thing for our country in the long run.”

ACADEMIC CASE #3

I have taught business ethics at a couple of different institutions, and I would say that probably 100% of the students believe that caveat emptor rules. It doesn't matter where you are teaching, the answer students give every time to an example of something that looks unfair is that the buyers involved 'should have known better' or that they 'should have done their due diligence.' It does not matter whether



“You have to work with a professional.... You have to put a lot of faith and trust in that person. There is no one silver bullet.”

Bud Schiff

the example concerns inner-city blacks or stock market participants. Regarding the participants in the stock market, I ask all of my students, ‘So the message I should take away is that someone like me, an unsophisticated investor and a retired professor, should simply get an index fund?’ Unanimously the answer is that I shouldn’t be in the market. They were saying to the average person, ‘The game of equity is not your game. You can’t play that game because that game is a game of strict caveat emptor. We understand this game and so we can play, but you should stay out.’ So my question is—do you think that these students are right?

Peter Tedone wanted to answer Bowie’s question directly, “The answer is ‘no’. We shouldn’t prevent that average investor from purchasing whatever product they think is best. This is America. We have to stop protecting people from themselves because when we do that we simply create generations of people who are financially illiterate. The average consumer gets no formal education about checking accounts, insurance, investments. That’s what we ought to be spending our energy and resources on, as opposed to protecting people from their own decisions.”

Norm Bowie wasn’t convinced that financial literacy would solve the problem. “Financial literacy assumes a fair playing field. It presumes all the good assumptions about how markets operate. There is none of the information about the ‘dark side’ of markets in this curriculum. Even if people are much better educated on things like checking accounts, that will not help them understand these sort of financial products.”

Bud Schiff believed that there were many good products in the marketplace, but most people needed the expertise of a financial services professional. “You have to work with a professional. You have to work with someone that is well educated and who really understands your objectives and the products that are available. You have to put a lot of faith and trust in that person. There is no one silver bullet.”

ACADEMIC CASE #4

I’m interested in learning from the executives how corporate responsibility evolves or takes shape. Let me make that more concrete by offering an allegory or a hypothetical case. Imagine a video game company that makes very sophisticated video games that involve a lot of sex and violence. These games are very popular among age groups that go from 16-35. They have some of the



best software engineers and programmers available in the country to make these games realistic. It's exciting to get a job at this company because the designers have the resources to do some cutting-edge stuff. The latest technology enables the player to participate in the game through mimicking the relevant bodily movements. You actually go through the motions of raping, killing or whatever the game is about. You could ask the question, 'Is this a successful company?' One answer would focus on how the shareholders are doing, and they are doing very well. But a more nuanced analysis wouldn't only ask about the shareholders, but would also consider how the other stakeholders were doing as well. And as we start looking at the stakeholders, we can see that they also seem to be doing well. The employees are making a good wage doing work that they enjoy. The customers really like the product to the extent that it is difficult to keep the games on the shelves. The community in which this company is located is getting tax revenues like crazy. And suppliers have the opportunity to develop and sell new kinds of equipment and new technologies, so they are thrilled. The problem that this allegory or hypothetical case presents is simply that, even though all the stakeholders appear to be doing well, there is this gut-level intuition that there is something seriously harmful about a generation desensitized to violent and criminal types of behavior.

What I want to know is whether there are circumstances in which you wonder about the social contribution of a particular product or practice? Have you experienced situations in which all of the stakeholders seem okay with what is going on, but you are not okay with it? And if so, do you feel some obligation to collaborate with other institutions to make a change, even if you may not be able to change society on your own?

Peter Tedone offered an example. "There is a product called credit insurance which is not considered a great product for the consumer for a number of reasons, one of which is that it is very high priced. In 1999, when I became CEO, we had been selling credit insurance in banks. Banks loved this product because it generated a great deal of fee income for them. I didn't like the product. I felt it was difficult for us to be consumer-oriented with the majority of our products and have this one line of products that were the 'violent video game' of the insurance industry. And I had to make the call. No one was forcing me to make the decision. I could have done nothing. Now, to this day most of those banks still credit insurance, but they do it for some other insurance company. We don't sell it."



“The good news is all of the troubling cases were second-hand, and the good cases were first hand. It is helpful to have the good cases to look at, rather than always the disasters.”

Joe DesJardins

Ken Goodpaster thought that decisions like this took a lot of courage. “It takes nerve to run the risk of sticking your head out and having somebody chop it off being a moral crusader.”

Jayne Schiff was reminded of another example. “Cancer insurance is another example of a product that seems to lack social value, but is supported by multiple stakeholders. I was always amazed that people wanted to be that specific regarding the risk they wanted to insure themselves against. If you are going to allocate a certain amount each month to protect against risk, it makes much better sense not to limit yourself.”

Jim Mitchell offered an example regarding an industry practice. “Agent retention has always been a problem in the financial services industry. In our organization the attrition rate was better than the industry average, but that still meant that after four years only 13 out every 100 people we had recruited were still with us. We looked at this and said ‘we have got to do better’. We had a feeling that, even though our customers and all of our other stakeholders were delighted with us, we were succeeding on the back of those 87% of the people who had failed. We eventually raised our retention rate from 13% to around 30%. I am not necessarily proud of that, but at least we caused less damage and more than doubled the number of people who went on to have careers with us.”

ACADEMIC CASE #5

My question is in response to some of the cases brought up by the executives in today’s discussion. There is something I call the “me too” phenomenon where people explain their behavior on the basis of the fact that “everyone is doing it.” I think that we saw this during the subprime loan crisis, but it also applies at the company level. Obviously the “me too” phenomenon can have both good and bad consequences, depending on whether ethical or unethical behavior is emulated. That is why it is so important to encourage leaders to act in morally courageous ways. Their behavior and attitudes will be adopted by the people around them. What I want to know is how do you teach moral courage? How do you get people to stand up for what they believe is right?

Tony Garcia believed that, as a starting point, educators need to emphasize the importance of working at an organization that reflects their values. “Students need to interview the company, and this has to be more than ‘what is my salary and how many weeks of vacation do I get?’ We have to



encourage young people to ask questions like, 'What are your values and how are they lived in this company?' Young people get disillusioned when they pick the wrong company with the wrong culture at the beginning of their careers."

Jayne Schiff wasn't confident that young people are able to distinguish between an ethical and an unethical company. "We would all like to believe that students right out of college would be able to recognize a company with good values and a strong ethical culture. But in order to do that, you need to have had experiences of how a company should be run and what ethical leadership looks like."

John McCall thought that turning off the pipeline of talent to unethical companies might be the best way to force ethical change. "If young people get into an unethical culture then they are going to be negatively affected by that social group. It's going to be very hard for them to speak up and very hard for them to change the system once the culture is in place. An organizational culture is designed to reproduce its own values."

Peter Tedone agreed with McCall and suggested another challenge for young people. "One of the reasons I think that students have a hard time recognizing unethical organizations is that unethical behavior and attitudes emerge over a period of time. And by the time they would be able to recognize the organization as unethical, they are already thoroughly embedded in that culture."



Ron and Brenda Duska and Linda and Jim Mitchell at the reception



“As an ethical organization, you’re in competition with companies that have a very different view of ethics. You’ll have to accept some missed opportunities that other companies exploit because they have different values.”

Tony Garcia

CREATING AN ETHICAL CULTURE

Jim Mitchell shifted the conversation to the importance of creating an ethical culture. He asked two questions: “How do you create and sustain an ethical culture? What are the obstacles, and how do you overcome them?”

Bud Schiff believed that an ethical culture begins with the leader of the organization. “I think the character of the organization is set by the person at the top. That person has a responsibility to drill the message that ethics is important down to his or her subordinates and so on throughout the organization. The message has to be that ‘To be successful at this company you need to act ethically’. And you need to reinforce that by promoting and rewarding people for getting it right.”

Tony Garcia suggested that a challenge to creating and maintaining an ethical culture might be giving up some short-term potential for growth.



Norm Bowie and Pat Werhane at the final dinner

“As an ethical organization, you may be in competition with companies that have a very different view of ethics. You’ll have to accept some missed opportunities that other companies may exploit in the near term because they have different values. But I am convinced

that over the long term, highly ethical companies will do a far better job in creating value for their key stakeholders.”

Peter Tedone thought that maintaining an ethical culture might be easier at a smaller company. “We talk about ethics at every one of our employee meetings. You have to keep it at the front of people’s minds, and use every single example you can come across to promote ethical behavior.”

Ken Goodpaster mentioned a thought-experiment he used in the classroom. “I ask my students to consider how they would kill the ethical integrity of



an organization if they were trying to kill it. I think that there are two ways. The first is that you could 'suffocate' it, which is to cut its life off from the outside. This reflects how powerful external forces can put pressure on a company to change its values. The second way is that you can kill it from the inside by 'poisoning' it. You poison an organization by hiring people into that organization that don't share its values. If you do that, the next generation coming through the pipe is going to kill the value system that you have done so much to create."

Mitchell noted that there are very tangible ways to reward people for ethical leadership. "Every year at American Express, we did an employee survey. The survey had the same questions year after year, which basically concerned how were we living our values. One-third of my annual bonus was a direct result of how my organization did on that survey. We literally paid people to create the culture that we wanted, consistent with our values."

CONCLUDING THOUGHTS

Jim Mitchell asked the group to share their thoughts on two questions: "What did you get out of your participation today?" and "What will you reflect on tomorrow?"

Peter Tedone said he gained a greater appreciation for the shared challenge academics and executives face in training ethical leaders. He added that it was helpful to see, "how other business leaders are dealing with the same problems. That's very valuable because there is no one to talk to about a lot of these things. It's pretty lonely, so you need this sort of environment."

Joe DesJardins noted that he was able to get details he was hoping for in the conversation with the executives. He was also glad to get some new ideas to bring back to his students. "The good news is all the troubling cases were second-hand, and the good cases were first hand. It is helpful to have the good cases to look at, rather than always the disasters."

John McCall shared that he would come away with two things. "The first is a greater sense of the sort of granular level things people have to look at when making decisions. The second is a series of examples that allow me to counteract a tendency among students to assume that the only thing a top-level executive is ever concerned about is the bottom line. There are always other values in play."



Norm Bowie was glad that he was able to get a better understanding of the financial services industry, especially the difference between life insurance products and investment products. But the big question for him concerned the increasing sophistication of the products on the market. “If we live in a society which is technologically very sophisticated and which develops very sophisticated products—how do we get the moral piece to catch up? How do we make sure that we are moving in the right direction?”

Tony Garcia appreciated the opportunity to share stories and experiences with the group. “I appreciate the engagement, and it actually got me thinking about some things I can do better.” In terms of what he would think about tomorrow, “I’m going to start thinking about a business ethics curriculum and maybe considering doing some teaching some day.” In terms of take-aways, he was planning to facilitate a discussion like this with some of his senior people. “I am very fortunate to be part of a mission-based company with a wonderful value system. I will reinforce that with my team and share what I learned from this day with the group.”

Jayne Schiff shared that she was able to learn how ethics was taught in the classroom and was interested to hear how the other practitioners thought about ethics. She thought that tomorrow she would reflect on, how, “ethics” is the foundation of this business. Ethics is really important. I think that the insurance business is a fabulous business, but it is only as good as our ethics. It was good to see that every person here today believes that.”



Ron Duska and Peter Tedone listen to Jim Mitchell

Ken Goodpaster realized that, “As academics we tend to think of certain phrases and terms as the conventional ‘code’ for ethical discourse. But frequently when leaders are talking about ethics, they talk about it in

business terms. They don’t use the same ‘code’, but they are talking about the very same reality that we are teaching. That is why it is a real benefit for academics to hear how executives talk about ethical issues.” Regarding what he will think about tomorrow, he added that, “John F. Kennedy wrote a famous book called Profiles in Courage. I heard a lot about moral courage today. And I think it would be neat if we had a book on profiles in moral courage that was written by executives based on their own experiences. If we had a book



of case studies in courage, we could try at least to help our students find that courage through emulating these leaders.”

Bud Schiff appreciated the chance to sit and reflect on ethics, which is an opportunity that rarely comes along. He also gained an appreciation for the role of academics in instilling ethics before students enter the workforce. He hoped that the academics were able to appreciate that, “not all companies are ‘slimy’. There are some really good companies out there who are trying to do well by their clients.” In terms of what he would think about tomorrow, he mentioned an idea he had while preparing for the meeting. “I will take some of my top people and work with them on a case study, maybe I’ll even use the case that we looked at today. I’ll set it up like the environment we had here, with no conference table, and see what comes of it. I think there is a lot of value in something like this.”



Pat Werhane, Ken Goodpaster and Tony Garcia enjoy the final reception

Pat Werhane said that she appreciated the chance to learn more about the financial services industry. “This was my third time attending the Forum, and I always appreciate learning many more nuances about the industry.” She added that tomorrow she will think about how to incorporate what she learned today into her teaching. “We should always reflect on how we can be better teachers and learners. It is a process, and we can’t get discouraged. We have to press on, and that’s what I’ll do.”

Julie Ragatz was glad to see the process of preparing for the Forum come to fruition in the wonderful day of dialogue. “We have been working on this case and the supporting materials for a couple of months, so I am delighted that you found it valuable. More than any other case we worked on in the past, this case was truly collaborative.” In terms of what she would think about tomorrow, “I want to continue to think of ways we can bring executives and academics together because I believe that both groups benefit so much from the experience.”

Jim Mitchell began by noting that he found the day an “absolute joy” and thanked everyone for their participation. He shared that the day’s discussion got him thinking about the question “How you can create an ethical culture?”



A lot of my thinking has revolved around the employees of the organization, but today reinforced the centrality of a focus on the client. That in my mind is absolutely the Number One thing you have to do in creating an ethical business. Tomorrow," Mitchell added, "I'm going to reflect upon what I reflect upon on other days: How we go about improving the level of ethical behavior in the financial services industry. I believe that the level of ethical behavior is actually pretty high. But clearly it could always be better, and we have to keep working on that."

Ron Duska said that he was still wrestling with the implications of the case. "I'm not quite sure how to frame it and how to work out for myself the relationship between business ethics, government regulation and economics. I have a suspicion that businesses are a heck of lot more ethical than government. It's a question that I will keep thinking about." He added that he had expected to have a good time and he did. "I really like being able to sit and talk these ideas out with both the academics and the executives—I believe that we each come away with something important."



Pat Werhane listens to Bud Schiff's case study



The James A. and Linda R. Mitchell/
The American College Forum on
Ethical Leadership in Financial
Services

The American College Center for Ethics in Financial Services is the only ethics center focused on the financial services industry. The Center bridges the gap between sound theory and effective practice in a way that most ethics centers do not. Under the leadership of Director Ron Duska, PhD, the Center's mission is to raise the level of ethical behavior in the financial resources industry. We promote ethical behavior by offering educational programs that go beyond the "rules" of market conduct, help executives and producers be more sensitive to ethical issues and influence decision making.

The Mitchell Forum is a groundbreaking, one-of-a-kind event that underscores the Center's emphasis on collaboration and conversation among academics and practitioners. Jim Mitchell was recognized in 2008 for his dedication to business ethics and was included in the "100 Most Influential People in Business Ethics" by *Ethisphere*, a global publication dedicated to examining the important correlation between ethics and profit. The list recognizes individuals for their inspiring contributions to business ethics during the past year.

The Forum is the cornerstone of the Center's activities highlighting how to bring industry leaders, accomplished producers, and prominent business ethicists together to reinforce the need to connect values and good business practices.



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