Incentives and Sanctions

Corporate Culture and Financial Reform

St Paul's Institute has worked with the Institute for Regulation and Ethics at the Centre for Commercial Law Studies of Queen Mary University to bring together 30 financial sector professionals, academics, regulators and reformers to discuss the different roles that incentives and sanctions can play in influencing culture.

The predominant focus in the current landscape of reform has been to take a punitive approach. It is natural for a significant amount of additional sanctions to be the response to the scale and types of misconduct witnessed in the recent global financial crisis. However, we need to also focus on the incentives side of the equation and much can be learned from social science and behavioural economics in these areas. How can financial institutions reconsider their culture and purpose so that they are perceived as trustworthy by their stakeholders? Can they incentivize their staff in non-monetary ways to reinforce positive behaviours?

Boundaries between right and wrong behaviour are not always straightforward.

Many people recognise the need to move away from external motivators such as monetary reward.

There is a strong business case that recognises the rewards for a business that creates a culture of ethics.

Widespread misconceptions that adhering to ethical standards results in 'business prevention' need to be challenged.

The true culture of an organisation is difficult to grasp from the outside.

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The discussion was held in December 2015 under Chatham House Rule. Here are some key themes and points:

Sanctions as Deterrent

- The logic of sanctions reaches a point where punishment cannot be a sufficient deterrent, because either the monetary rewards are too great or the logistics of punishment reach a meaningless level (i.e. 150+ year prison sentences).
- Setting extremely high levels of sanctions across the board can make it difficult to differentiate between really egregious conduct and milder transgressions.
- Defining the boundaries between right and wrong behaviour is not always straightforward, and becomes increasingly difficult as financial systems and innovations become more complex.
- The more granular regulation is, the easier it becomes for those who are regulated to start assuming (wrongly) that all they have to do is follow the regulation.
- Senior people who don't have the right culture need to be sacked.

Incentives as Reward

- Sanctions, law and regulation are more about discouraging poor conduct than they are about encouraging an aspiration to best behaviour.
- A lot of people recognise the need to move away from extrinsic motivators (such as monetary reward) to intrinsic motivators: higher purpose, personal growth and mastery, social connectedness and autonomy.
- Ethics, a sense of duty and an understanding of purpose have been broadly identified as productive areas to focus incentives on.
- That incentives offered by ethics are measured in terms of respect and standing as well as satisfaction in work.
- There is a strong business case that recognises that the rewards for a business that creates a culture of ethics take the form of attracting and retaining talent; enhancing sustainability; building reputation and competitive advantage; building brand and protecting a business from expensive penalties.
- Beyond following codes of conduct there is a higher duty to ensuring the efficacy of the financial sector as a whole and the benefits it can grant to society.
- It's rewarding to be looked up to as a role model and to be asked by others for guidance.
- Professional qualifications provide a high degree of training and instruction, as well as affirmations to a code of ethics and standards of professional conduct.
- Many people began to see bonuses as an entitlement rather than a reward for good performance.

The Psychology of Culture

- Giving individuals responsibility for designated areas might be the most appropriate way of getting people to take responsibility for their actions and decisions.
- Financial sector professionals often have to choose how to behave to win internal competition and be considered for promotions and other long-term rewards.
- A recent study has determined that people's behavioural choices at work were strongly determined by the emotional state they were in at the point of making the decision. Anxious people act more unethically, excited people act more innovatively.
- Negatively framed consequences make people more anxious, which consequently makes them more likely to behave unethically. Negative consequences are also often handed down the chain of command.
- Good and right leadership often does more to change culture than either incentives or sanctions. Leadership works best that understands from top to bottom and has a connection with the furthest points of the business.
- Leaders are often unaware of the amplification effect of their behaviours on others. Increased development and training around self-awareness can be highly beneficial.
- Many people are not faced by the need for moral judgement in decision making because they do not have a clear understanding of the consequences of those decisions.
- People are empowered if they feel valued, but equally if they don't feel valued and hate their job the only incentives they will look to are financial.
- Avoiding ostentation in head offices and senior management can help send a clear message on culture.
- Rules must be consistently implemented and the same for everybody in the institution; this starts from the moment you hire people.

Landscape of Financial Services

- When competition works well, firms compete to provide consumers with what they want and need – and lose market share if they fail to do so.
- By defining shareholder value as a simple measure of price movement, we have brought it down to too narrow an interpretation of what value truly is.
- Mark-to-market accounting permitted unrealised gains to become a contributor to earnings per share. Some senior managers were being paid larger and larger bonuses on the basis of what were unrealised gains. When trends reversed, unrealized losses were difficult to claw back from compensation.
- We need a better mechanism for interpreting culture from outside the institution and including it in the value we assign to financial services businesses.
- There is a widespread misconception that adhering to ethical standards can result in 'business prevention' – that it stops activity. It's important to challenge this perception and empowering a more forthright view on ethical action.

Society and the Common Good

- Duty to the customer or client alone is no guarantee of proper conduct. Indeed in some contexts it can lead in the opposite direction to good conduct. Alongside a sense of duty to customers and client must rest a sense of duty towards the wellbeing of society as a whole.
- The purpose of finance is to help society enable, create, achieve and develop; and thus a sense of reward is available more widely than just in monetary form.
- When talking about incentives, sanctions and creating a better culture – are we looking at this from the point of view of senior management or society and the regulator as the voice of society?
- We need to figure out the right indicators that allow us to genuinely identify the culture of a business.

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