



Missed Behavior

Can cognitive biases explain unethical behavior?

BY LORI PIZZANI

The identification of behavioral insights isn't inherently good or bad. Nor do such insights explain why some individuals behave unethically while others are down right saintly. Insights about behavior can be used positively or negatively in much "the way that insights about nuclear energy can be used to produce electricity or make bombs; or insights into chemistry used to create medicines or make poisonous gas," says Werner De Bondt, chairman of the Driehaus Behavioral Finance Center at DePaul University's Kellstadt Graduate School of Business in Chicago.

Those who apply this knowledge can take advantage of weaknesses, De Bondt says. But determining what is and isn't ethical behavior isn't cut and dried, he adds. In his view, "What is unscrupulous behavior and what is within the limits of acceptable behavior is a cultural phenomenon."

Self-Serving Bias

Ethics can become an issue when certain biases are played out, depending on the venue. Behavioral experts have identified something called the "self-serving bias," which explains how individuals tend to select comparative standards, or reference points, that serve their particular situation and are (not surprisingly) self-serving, according to Richard Thaler, professor of behavioral science, economics, and finance at the University of Chicago Graduate School of Business.

For example, if a professor approached the dean of his college to complain about his inadequate salary, it's likely the professor would reference another professor who earns more money but does less work, Thaler

points out. To support his claim, the professor desirous of a raise would tend to neglect to mention yet a third professor who works the hardest of all but earns less than both other professors. "The subtle thing about this bias is that people do it at least partially subconsciously, which partly explains why everyone can think they are underpaid," he says.

While this may sound innocuous enough, that very same bias can be much more severe when applied to other situations. Ethical problems arise because "some of the people who commit crimes justify it to themselves," Thaler explains. They may say, "Sure, I am trading ahead of my clients, but the way I hear it, the competition is doing much worse things." Once things get started, says Thaler, "we know there can be enormous peer pressure to go along."

Lining Up Incentives

Thaler also notes that businesses are often guilty of misaligning incentives, although their intentions may be good. There is a "not so well appreciated danger of making incentives too explicitly linked to measured performance, for example, linking annual bonuses to the profits of a manager's division," he counsels. "While such schemes are often designed precisely to line up incentives, they often backfire."

KEY POINTS

- Behavioral insights don't dictate or concretely predict whether an individual will act ethically or unethically.
- But behavioral analysis can help identify ethical problem areas to avoid.
- Ethical judgment is affected by cultural influences, including corporate incentives/disincentives.

Frequently, the long term is sacrificed for the short term and internal teamwork can be inhibited. Incentive schemes can also have the undesired effect of pitting one department against another as competitors.

Seen through the lens of agency theory, a public company's principals (owners) and their agents (managers running a company) don't have the same interests or desires. In the 1990s, some suggested better aligning those interests.

Tying executive compensation to the performance of a company's stock through the use of stock options was supposed to align the interests of corporate executives to the interests of stockholders. If the stock price rose, it would be a win-win situation, argued proponents. Instead, the practice drove unscrupulous company managers to manipulate corporate accounting and pump up the stock price at any cost. Many now agree, with the benefit of hindsight, that compensation linked solely to the company's short-term stock price and not to long-term measures had unintended and negative consequences for shareowners.

"I think it is naive to align compensation this way. [The result] was

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MAXIMILIAN TORRES
Associate Professor
Ave Maria School of Law

predictable,” says Maximilian Torres, associate professor of law at the Ave Maria School of Law in Ann Arbor, Mich. People shouldn’t be expected to do the right thing, notes Torres, “when all they see are dollar bills falling from heaven.”

Finding the Right Balance

According to Torres, there are three parts to humans: the belly, the head, and the heart. In his view, “[managers] are constantly being fed at the level of the belly to the point that their heads and hearts shrivel up and the belly takes over.” Calling for “more of a focus on moral judgments that manifest as personal integrity, he says, “We must teach people how to have non-financial things that move them.”

Does putting the focus on a stock price help managers run businesses better? “It’s not clear that it does,” says Brad Agle, associate professor and director of the David Berg Center for Ethics and Leadership at the University of Pittsburgh Katz Graduate School of Business. A competing theory, the stakeholder theory, which emphasizes taking the needs of employees, clients, vendors, and others into account, is now in vogue, he notes. “When you take a stakeholder approach, people think differently,” he says. Rather than focusing solely on the stock price, they are more likely to strive to make customers and employees happy, with the assumption that doing so will be better for the company. The challenge, according to Torres, is constantly finding the right balance.

At least part of the problem is cultural. “We have a culture backed by incentives and disincentives,” suggests Heidi Ravven, professor of religious studies at Hamilton College in Clinton, NY. But these incentives and disincentives do not always work to promote ethical behavior. For example, there may be disincentives that prevent ethical individuals from doing what they would otherwise be naturally inclined to do, such as blowing the whistle on an unethical employee or revealing that a medical product has a flaw.

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If men were angels, we wouldn’t need laws.”

DANIEL WUESTE

Director

Robert J. Rutland Center for Ethics, Clemson University

Building around Biases

For many executives in power positions, cultural biases toward the freedom to choose has included “the freedom to choose greed and abuse of power,” says Diane Swanson, founding chair of the business ethics initiative and associate professor of management at Kansas State University in Manhattan, Kan. In 2004, Swanson and a professor at the University of Auckland in New Zealand conducted a preliminary survey of 200 business executives in Australia and uncovered links between ethics and levels of executive compensation. “We found,” she says, “that executives who said that they downplayed ethics and value in their decisions were also the ones who self-reported a desire for extraordinary salary levels — many multiple times employees’ levels.”

Swanson, long a crusader for business schools to require deeper ethics curriculums, believes fundamental personality differences may play a large role in determining whether an executive acts selfishly or selflessly. She believes there’s a need for more research on personality types and recommends that incoming corporate executives undergo personality screens, potentially conducted by the board of directors, to weed out those with undesirable traits.

If Men Were Angels

A key point of contention among those who have long studied human behavior is whether or not people can be held accountable for their actions, explains Daniel Wueste, director of the Robert J. Rutland Center for Ethics at Clemson University. Famed behavioral psychologist B.F. Skinner denied the existence of free will and believed in programmed conditioning to a stimulus. “When look-

ing at the world from an ethical view, we assume people can be held accountable. But if the behaviorists are correct, then people cannot be held accountable for their actions,” Wueste says.

Being aware of behavioral biases is helpful in planning to avoid difficulties. Wueste points to the example of an automotive repair business that tied the compensation of its mechanics to the volume of repairs performed. The result was that unnecessary repair work was performed and lawsuits followed. “If you don’t put limits on gains,” he says, “some people will go too far.”

According to Wueste, ethics is driven by the knowledge one has of whether a particular action is acceptable or not, but the reality is that even when some people know that it’s wrong, they’ll do it anyway. “Law is the added layer to protect rules,” he adds, paraphrasing James Madison: “If men were angels, we wouldn’t need laws.”

Lori Pizzani is a freelance financial writer based in Brewster, N.Y.

RECOMMENDED RESOURCES

“On the folly of rewarding A while hoping for B”
Steven Kerr
(<http://pages.stern.nyu.edu/~wstarbuc/mob/kerrab.html>)

“Monkey Business: A Neo-Darwinist Approach to Ethics Codes”
Financial Analysts Journal (May/June 2005)
(cfapubs.org)

“Why Ethics Codes Don’t Work”
Financial Analysts Journal (November/December 2003)
(cfapubs.org)

“Ethics and Investment Management: True Reform”
Financial Analysts Journal (May/June 2005)
(cfapubs.org)

“Understanding the U.S. SEC’s Code of Ethics”
2005 CFA Institute Webcast
(cfawebcasts.org)