Chapter

11

Unethical Behaviour in the Dutch Financial Industry: an Empirical View

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11.1 Introduction

Unethical behaviour has gained specific attention in the public debate about the causes of the financial crisis that began in 2007. This crisis has been blamed on a variety of factors and it is likely that its compound roots will be debated for decades to come. Among the multiple constituents identified as having caused the financial crisis, one of the core causes is assumed to be weak corporate governance (De Larosière, 2009) that resulted in the gradual collapse of ethical behaviour across the financial industry. "In this world-wide financial crisis, it became explicitly clear that the irresponsible (and unethical) behaviour of managers and organizations inflicts pain on society and its members" (De Cremer, 2009: 3).

Dick Fuld, the former CEO of Lehman Brothers, is often identified as one of the schemers of Wall Street who has directly contributed to the economic bubble and subsequent collapse of the banking sector. The 'Gorilla of Wall Street', as Fuld was known, steered Lehman deep into the business of subprime mortgages: bankrolling lenders across the United States that were making convoluted loans to questionable borrowers. The firm combined all these dodgy loans into bonds, and thus passed on to investors billions of dollars of what is now commonly regarded as toxic debt. For all this wealth destruction, Fuld raked in nearly $500 million in compensation during his tenure as CEO, which ended when Lehman went down. Recent high-profile corporate scandals in the financial world, such as exemplified by Lehman, have raised the question as to whether unethical conduct is idiosyncratic only for some extraordinary bank executives, or whether it is generally prevalent among employees in this sector.

This chapter aims to shed light on this question based on empirical research outcomes. Firstly, a set of determinants of unethical behaviour of employees will be identified. Next, recent empirical evidence will be presented to discuss contextual factors that explain and predict unethical behaviour in the financial sector. Finally, some directions for further investigation will be suggested.

11.2 Determinants of unethical employee behaviour

In general, ethical decision-making models divide the influences on an individual's ethical behaviour into two broad categories: individual characteristics and contextual factors (e.g. Meyers, 2004). The first category includes variables that are uniquely associated with the individual employee. The second category consists of variables that devise and define the situation in which the employee makes decisions. This category includes a variety of situational factors that represent the situational pressures that come to bear on the individual and either encourage or discourage ethical decision making (Ford & Richardson, 1994). Research has shown that unethical behaviour observed in organizations involves a complex mix of these individual and contextual factors (Bazerman & Banaji, 2004), suggesting that most people may engage in unethical behaviour under the proper circumstances.

Factors at the individual level include individual contingency factors, personality, attitudes, dispositions, values, education, and cognitive moral development (O'Fallon & Butterfield, 2005). Although individual characteristics are important predictors of unethical behaviour, they are also notoriously resistant to change. Individual characteristics, like personality and ethical attitudes, may be particularly resistant to change since they rest on values that are generally developed over time and have developed as a result of cultural, family, and religious affiliations (Armstrong, Ketz, & Owsen, 2003).

The role of organizational factors seems more important from a practical perspective than individual characteristics, since managers have greater control over the work environment than they do over the employee's personality, values, or moral development.

At the organizational level, both the informal and the formal organizational context are assumed to relate to unethical behaviour (Treviño and Nelson, 2007; see figure 11.1).

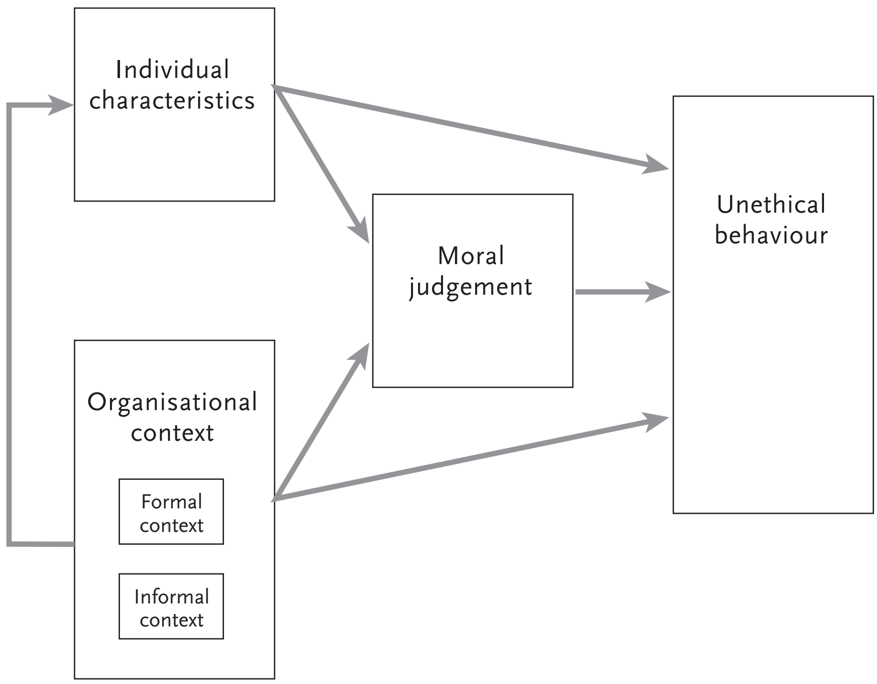

Figure 11.1 Categories of influences explaining the unethical behaviour of employees

Brickley, Smith and Zimmerman (1995) have argued that changing the formal organizational context is more straightforward and more effective than changing the informal context. They also argue that it is the structure of the organization that determines unethical behaviour. Treviño (1990) takes a different perspective: the informal context contains the most relevant factors to explain employee unethical behaviour. In this paper, we will present empirical evidence that supports Treviño's position.

11.3 Formal organizational context

Formal context is that part of the organizational context that includes the organization's internal structure, selection systems, orientation and training programs, rules and policies, performance management systems, and formal decision-making processes (Treviño & Nelson, 2007: 261).

The internal structure of an organization embodies features of the formal organizational context. Brickley, Smith and Zimmerman (1995) have defined the internal structure of the organization as its 'organizational architecture'. This concept encompasses three critical control factors by which the firm can steer the behaviour of employees: the assignment of decision rights, the performance-evaluation system, and the structure of rewards.

Brickley, Smith and Zimmerman have argued that business ethics and organizational architecture are inextricably linked, because the organizational architecture establishes an important set of behavioural incentives for the individuals who comprise the firm. Expected theoretical effects of elements of organizational architecture are grounded in agency theory. Similar to most models of economic behaviour, this theory is based on the idea of the rationally self-interested *Homo economicus*, who is assumed to be driven by self-interest and opportunism and who is likely to shirk responsibility (Williamson, 1975; Nord, 1989).

The firm's organizational architecture can be structured to encourage individuals to behave in desired ways in their roles as employees and managers. Not doing so invites individuals to game the system and can result in the utter failure of well-intentioned policies (Brickley, Smith, & Zimmerman, 2002). From a theoretical point of view, it seems plausible that different aspects of organizational architecture may affect employee behaviour, although the results may be unintended. In designing the internal structure of organizations, it is critical that managers anticipate the potential responses of employees, customers, or suppliers that may produce undesirable outcomes. Brickley et al. (2002) stated that incidents of corporate wrongdoing and corporate scandals stem not so much from a general failure of corporate governance as from flaws in an important facet of corporate governance: the organizational architecture.

A classic example of how an inadequate organizational architecture can lead to utter failure is Barings Bank. Britain's oldest merchant bank, established in 1762, was brought down in 1995 due to unauthorized trading by its head derivatives trader in Singapore, Nick Leeson, and sold to ING, a large Dutch financial institution, for £1. Based on the theory of Brickley et al. (2002), it seems easy to identify three general aspects of Barings Bank's organizational architecture that, had they been different, might have prevented this debacle.

First, Leeson was able to engage in unauthorized trading because he was granted a broad range of authority and responsibility that enabled him to circumvent the bank's internal controls. He used that power to conceal his losses and disguise the true nature of his activities.

Second, a better-designed and better-executed performance measurement system would have identified these problems long before the solvency of the bank was jeopardized.

Third, the bank's compensation system facilitated managers to participate in annual profits but not in losses. Barings had traditionally paid out approximately 50 per cent of its gross earnings in annual bonuses. From 1992, Leeson made unauthorized speculative trades that at first made large profits for Barings: £ 10 million, which accounted for approximately 10% of Baring's annual income. He earned a bonus of £ 130,000 on his salary of £ 50,000 for that year. The compensation system not only encouraged Leeson to speculate, but also gave senior managers almost no incentive to exercise tighter control over their trader.

Incidents of corporate wrongdoing in the financial sector continue to transpire, and similar flaws in the organizational architecture as described Leeson's case appear to have brought about such problems in more recent times.

Kweku Adoboli was a trader at Swiss Bank UBS's Global Synthetic Equity Trading division as a trade support analyst. In 2010, he earned a £ 250,000 bonus on top of his £ 110,000 salary. On the 20th of November 2012, he was found guilty of fraud in connection with a loss of an estimated £ 1.4 billion due to unauthorized trading at UBS's investment bank, for which he was sentenced to seven years in prison.

Supported by the extensive media attention of such incidents of integrity breaches, specifically the remuneration policies have been postulated as causes of unethical behaviour in the financial sector. For example, according to Turner (2009: 79), "There is a strong prima facie case that inappropriate incentive structures played a role in encouraging behaviour that contributed to the financial crisis." Scholars from various scientific disciplines have responded to this notion, suggesting rigorous reform of remuneration structures within the financial sector in general and of the banking sector in particular. Proposals to prohibit variable financial reward systems in the banking sector altogether (Jonker & Bos, 2011) have also been voiced. Financial institutions have begun to drastically reduce the share of variable compensation, including bonuses, in their remuneration mix at all employee levels.

In response to these developments, there has been a renewed emphasis on the role and effectiveness of characteristics of both the formal and informal organizational context to manage unethical behaviour of employees.

There is, however, a paucity of empirical data on the extent to which an important characteristic of the organizational context, the organizational design, is related to unethical behaviour in the banking sector. Apart from limited anecdotal evidence of incidents of corporate wrongdoing at the top, as described above, empirical evidence that explicitly studies the relationship between aspects of organizational architecture and unethical behaviour of employees over a broad spectrum of hierarchical levels is scarce.

In a recent quantitative study among 988 employees representing all hierarchical levels of the commercial banking branch of one of the largest financial institutions in Europe, which is the first large scale study in this field in the financial sector in The Netherlands, Zaal (2012) has bridged this gap and has answered some of the emerging questions, thereby helping to clarify the role of a broad spectrum of formal and informal contextual determinants of unethical behaviour in the banking industry. One of the starting points of this study was the proposition that the three elements of organizational architecture are related to the observed frequency of unethical behaviour of employees over all hierarchical levels.

This study revealed that effects from organizational architecture theory do not explain unethical behaviour of employees. Within the bank under study, none of the aspects of organizational architecture was significantly related to the observed frequency of unethical behaviour.

A plausible explanation for this lack of relationship is that most individuals are not solely motivated by a narrowly focused self-interest. If, however, this is the case, individual motives, resulting from individuals' decision-making authority, structure of performance evaluation and reward system are not sufficiently strong to provoke unethical behaviour. This implies that it is unlikely that the amount of individual decision-making authority will directly influence the frequency of unethical behaviour. A narrow focus on the amount of decision rights assigned to managers and employees, with the aim of reducing unethical behaviour, is therefore unlikely to be effective.

It is also unreasonable to expect that organizations will be successful in decreasing the frequency of unethical behaviour by decreasing the extent to which various financial performance targets are used for performance evaluation.

An additional important finding was that monetary aspects of the organizational reward system are unrelated to the frequency of unethical behaviour. Although some evidence suggests that commission based monetary incentives that reward specific aspects of behaviour might result in unethical behaviour (Treviño, 2007), such a relationship was not found over the entire hierarchy of the bank being studied. Neither the extent to which individual financial performance is related to obtaining a reward, nor the size of the variable financial reward, is related to the frequency of unethical behaviour. This implies that it is unrealistic to expect that the frequency of a broad spectrum of unethical behaviour will decrease if the importance of financial targets used for performance evaluation is reduced. Furthermore, although organizations in the banking sector might consider reducing the size of variable financial rewards (e.g. bonuses) for various reasons, it may be unlikely that this will result in a decrease of the frequency of unethical behaviour.

Based on these findings, the conclusion seems to be justified that the executives who have shocked the general public by their widely debated unethical behaviour are merely examples of eccentric individuals. A narrow focus on a rigorous transformation of the organizational architecture of financial organizations is unlikely to prevent such incidents from happening again.

11.4 Informal organizational context

In order to effectively decrease unethical behaviour, it is more appropriate to direct managerial efforts toward the informal contextual factors.

Researchers concluded that among the informal contextual factors, organizational culture is considered to be one of the most important influences (Kaptein, 2008). Ethical culture represents a slice of the overall organizational culture and reflects a variety of informal control mechanisms that theoretically predict moral acceptability judgment and unethical behaviour (see figure 11.1). Several research studies have successfully linked attributes of ethical culture to unethical behaviour by employees (e.g. Treviño & Nelson, 2007). For example, Kaptein (2011) found that six of the eight tested ethical cultural practices had a negative relationship with observed frequency of a broad range of different unethical behaviours. The importance of ethical culture has also been adopted by the Dutch Central bank that has named this topic as one of the issues for the future of supervision at financial institutions (DNB, 2009).

As mentioned above, the unethical behaviour towards customers of the financial sector has been the specific focus of attention in the context of factors that caused the financial crisis. Zaal (2012) concluded that only a limited number of characteristics of the ethical culture are specifically related to unethical behaviour towards customers.

With the aim of decreasing unethical behaviour toward customers, Zaal found that the strongest effect is anticipated from managerial and organizational initiatives that are focused to increase the extent to which employees experience trust and respect in their working environment and the extent to which employees identify and endorse the norms and rules of the organization. The more employees experience trust and respect in their working environment, and identify and endorse the norms and rules of the organization, the less the frequency of unethical behaviour towards customers of organizations of the financial industry.

Notwithstanding the fact that it has a smaller effect, increasing the extent to which employees are enabled to act in an ethically responsible manner will decrease unethical behaviour towards customers. This vindicates managerial initiatives aimed at providing employees with more time, resources, and information to act in an ethically responsible way.

Apart from individual and organizational contextual influences, individuals' moral judgment is assumed to also be relevant for individual unethical behaviour (Butterfield, Treviño, & Weaver, 2000). Individuals' moral judgment about what constitutes right or wrong behaviour in a given situation is an important stage in the ethical decision-making process because it forces the individual to decide whether or not to engage in unethical behaviour (Treviño & Weaver, 2003). Previous research demonstrates that individuals' moral judgments are strongly predictive of their behavioural intentions regarding ethical issues (Bass, Barnett, & Brown, 1999). Unethical behaviour is therefore presumed to be influenced by the moral judgment of that behaviour, which serves as an internal psychological guideline or condition for actual moral behaviour (Treviño, 1986: 609).

The relationship between moral acceptability judgment and unethical behaviour was considerably stronger for customers than it was for other stakeholders of the organization. It is conceivable that when people judge unethical behaviour towards customers as morally unacceptable, they find it easier to follow through and refrain from such unethical behaviour (Robin & Forrest, 1996). One could argue that this is due to a higher moral intensity level of unethical behaviour towards customers, compared to other stakeholders.

Moral intensity refers to characteristics of unethical behaviours that compel the individual to employ ethical reasoning (Jones, 1991). According to Tsalikis, Seaton and Shepherd (2008), the most important components contributing to moral intensity of a specific type of unethical behaviour are magnitude of consequences (i.e. the total harm done to the victim), probability of effect (i.e. the probability that the specific type of unethical behaviour will actually cause the predicted harm), and temporal immediacy (i.e. the length of time between the present and the onset of consequences of the specific type of unethical behaviour). Within the banking industry, it seems reasonable to assume that unethical behaviour towards customers is characterized by a relatively high level of moral intensity because the magnitude of consequences and probability of effect of this type of unethical behaviour is presumed to be high, resulting in a high degree of moral intensity.

Both individual factors as organizational contextual factors are assumed to influence moral judgment (Treviño, 1986). Consequently, aspects of ethical culture are assumed to also influence unethical behaviour indirectly, via moral judgment. Two aspects of ethical culture were found to influence moral judgment of unethical behaviour towards customers. Clarity, the extent to which the organization makes it sufficiently clear how employees should behave themselves, and sanctionability, the extent to which unethical behaviour is punished and ethical behaviour is rewarded, are elements of ethical culture which only indirectly, through the construct of moral judgment, influence the observed frequency of integrity violations towards customers and employees.

11.5 Future research agenda

Apart from the characteristics of ethical culture as discussed in this chapter, a number of conditions possibly moderate the relationship between ethical culture and the unethical behaviour of employees. For example, the opportunity of employees to become involved in unethical behaviour and the effect of a broad range of preventive internal control mechanisms aimed to prevent such behaviour. A future research agenda could be focused on these conditions.

Except for these factors, research in this area has repeatedly demonstrated that peer pressure plays a major role in influencing unethical decision-making and behaviour. Given the fierce competition that characterizes the banking industry, it is conceivable to assume that in the context of this sector this might be specifically applicable. Researchers have traditionally limited their focus to social learning theory to explain the importance of peer behaviour. However, further insight could be obtained by considering alternative theoretical perspectives, such as social identity theory and social comparison theory. These perspectives may also provide valuable research opportunities in future research and will be explored to further explain the relationship between organizational factors and unethical behaviour of employees.

In summary, organizations in the financial sector clearly have a vested interest in nurturing integrity and discouraging unethical behaviour. Many business ethics theories focus on defining the content of (un)ethical behaviour, using traditional ethical theories such as utilitarianism, ethics of duties, and rights and justice (Crane and Matten, 2010). Recent empirical work suggests that managers and business organizations in the financial industry can continue to benefit from research that appeals to a broad range of social cognitive perspectives and that more attention should be paid to the organizational processes that foster unethical behaviour.

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