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COMMENTARY: New paradigms to tackle age-old governance problems

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NEW YORK (Thomson Reuters Regulatory Intelligence) - Since the creation of the modern corporation as a form of business, the issue of opportunistic behavior by managers has plagued shareholders. But new approaches to guiding behavior are offering alternatives to common governance failures.

Most governance arrangements have grappled with creating incentives for managers to act in furtherance of investors' goals, which is often about maximizing financial value. Increasingly, however, investors also seek to promote long-term stakeholder value, as shown by the 2018 BlackRock letter to CEOs(here). In that annual address, BlackRock CEO Larry Fink set an expectation that, beyond financial value, companies should work to benefit "all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate".
After the Great Depression of the 1930s, securities regulation and the progressively compliance-ridden regulatory structures for investment companies provided government-led mechanisms to protect investors against the downside risks of management decisions. Governments pursued this through mandatory disclosures and by regulating the safety and soundness of banks serving as intermediaries.

More recently, following the Global Financial Crisis of 2008, shareholders and regulators alike have renewed and sharpened their focus on behavioral risk. There is an ever-growing perspective that the effectiveness of enforcement-led approaches to managing behavioral risk has reached its limit. In particular, recent ethical failures, such as emissions evasion by VolksWagen(here) and the fraudulent accounts scandal at Wells Fargo(here), have led governance experts to question whether civil and criminal penalties have become merely another cost of doing business.

In the financial services sector, the recent regulatory emphasis on corporate culture indicates that policymakers too are considering broader supervisory approaches to address weaknesses in enforcement-led supervision. [See the Financial Stability Board's April 2018 report on Strengthening Governance Frameworks to Mitigate Misconduct Risk (PDF) for a summary of regulatory activity. (here)]

This leads to a few key questions about corporate governance. If financial risk metrics fail to capture misconduct risk effectively, should regulators also try to manage conduct risk? For those corporate executives who do wish to deliver clean results, how are they to know whether their own employees are likely to cause problems that could damage the entire franchise?

A recent analysis of the economics of misconduct risk by Kevin Stiroh[here], the head of financial institution supervision at the Federal Reserve Bank of New York, blamed "market failure" for the lack of firm-level investment in corporate culture. Stiroh suggested that managers often underinvest in preventing employee misconduct for the same

three reasons they underinvest in other aspects of governance:
— Externalities: Misconduct costs are often not borne by managers;

— Principal-agent problem: Employee interests do not align with those of shareholders; and

— Adverse selection: Firms known for excessive risk-taking may attract “bad apples” because of their reputation, causing a downward spiral of misbehavior.

The issue then becomes how to design policies that are likely to encourage better, more ethical behavior among employees.

UNDERSTANDING MISCONDUCT

Enforcement agencies have for years attempted to deter misbehavior through criminal and civil penalties. Recent behavioral science research indicates, however, that such approaches may reflect a misunderstanding of humans and the likely causes of misbehavior.

The journal Behavioral Science & Policy (BSP) dedicated a 2017 issue to developing policies that promote ethical behavior (PDF)[here], which guided policymakers on how the psychology of ethics and morality can inform regulations targeting corporate culture. Authors Nick Epley and Dan Tannenbaum wrote that our common-sense understanding of why people misbehave is often wrong, stemming from core myths about morality that also underpin misguided approaches to regulating misconduct.

Epley and Tannenbaum explained that ethics are often understood as a problem of people and their moral beliefs, rather than the product of social environments. “Common intuition presumes that people’s deeply held moral beliefs and principles guide their behavior, whereas behavioral science indicates that ethical behavior also stems from momentary thoughts, flexible interpretations, and the surrounding social context,” they wrote.

ENCOURAGING ETHICS VERSUS PUNISHING MISCONDUCT

The implication for policymakers is that exclusively focusing on bad actors is unlikely to deter future misconduct by others. Moreover, reliance on flawed assumptions about human morality can lead policymakers to overinvest in unproductive interventions, such as training programs that teach employees about a company’s values and legal compliance.

Policies that integrate behavioral ethics in the regulatory toolkit are more likely to elicit desired behavior.

Traditional anti-corruption policies are a good example. Yuval Feldman, another BSP contributor, wrote that classic approaches to enforcement may in fact inadvertently increase corruption. For example, while disclosure is the traditional approach to managing conflicts of interest, empirical research shows that people often become even more self-interested in their actions after they disclose a conflict. Consequently, conflict disclosure policies should be accompanied by recusal and disqualification requirements.

Feldman offered tools inspired by behavioral science research that could help curb corruption. The most widely used alternatives are nudges, changes to the environment, and choice architectures that remind people to prioritize the best interest of a third party. For example, crafting disclosure forms that require people to sign before completing the form would make ethics more salient in the process. Additionally, frequent reminders of positive, ethical behavior among a group can shift perceptions of norms toward more desirable behaviors.

Other approaches offered by Feldman include targeted policies recognizing situational factors that may increase corruption. Evidence shows, for example, that some scientists in pharmaceutical companies are motivated to cut corners in clinical trials, not because of financial gain, but because of prestige. Financial fines are therefore less likely to deter those scientists, compared to profit-minded business managers at the same company facing the temptation to increase sales through deceptive marketing practices.

CULTURE AS ROOT CAUSE

Behavioral science findings about ethics and the shortcomings of traditional policy leave an opening for policymakers to examine other systems that can encourage the outcomes they seek.

One such system is internal culture. In the BSP article “Regulating for Ethical Culture,” Linda Trevino, Jonathan Haidt, and I describe the critical need for corporate culture assessment, so that managers can more effectively understand where to concentrate efforts to improve ethics. The most effective ways to assess culture draw from validated, reliable, and standardized tools, including surveys, focus groups, and interviews conducted by a trustworthy third-party.

Employees are more likely to respond honestly if their responses are shielded from managers and regulators. In the article, we also review the existing academic literature on how to assess ethical culture, the results of which have led to the creation of a new framework for assessing ethical culture, developed by Ethical Systems(here).

A critical role for regulators is to require that companies conduct meaningful root-cause analysis and cultural assessments to generate a self-critical understanding of their organizations. Regulators, however, must pursue a careful balance. They should ask questions about internal policies with respect to culture – encouraging the development of learning organizations that enable employees to grapple with challenging ethical issues – without accessing the underlying data and results generated by the company. Regular review of raw data by regulators could inadvertently lead to companies gaming the system.

Introducing lessons and research from behavioral science into corporate governance can open new avenues for reconsidering how investors, regulators, managers and all employees interact with and within a corporation. Policymakers have a fresh chance to provide new approaches to long-standing issues of market failure and lapses in corporate culture.

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