Behaviour and Compliance in Organisations

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Summary

No-one should underestimate the challenge faced by financial regulators in ensuring compliance with the extensive rules, principles and guidance that govern conduct of financial services. Regulators' approaches to compliance have tended to combine the use of detection and punishment to change firms' incentives through strategies of 'credible deterrence'. Insights from psychology suggest that these strategies can be complemented by an approach that seeks to change the 'choice architecture' of compliance decisions. This paper draws on those insights to discuss the complex range of factors that influence effective compliance and provide suggestions for how regulators and firms can improve levels of compliance.

While behavioural biases in consumer decision making are well documented, it is less well recognised that many of these same biases can affect the way that people take decisions in a professional context. The resulting preferences, beliefs and decision making processes can make rule breaking appear attractive to an individual and, if not recognised, allows firms to maintain faulty governance processes. However, with appropriate understanding, regulators can also exploit these biases to change perceptions of detection and punishment, while firms themselves can use internal scrutiny and decision tools to de-bias their decision making and improve their internal controls.

Also relevant are conceptions of the morality of behaviour and the social context of decisions, which can materially influence compliance behaviour. People's actions are constrained by their desire to see themselves as virtuous, moral people, meaning that rule breaking can be reduced by enhancing the role of morality in decision making. This can involve using moral codes and reminders and increasing awareness of the negative consequences of non-compliance for consumers.

People behave differently when they are in groups, meaning that rule breaking depends on the culture and social norms within firms. Wrongdoing can, therefore, be reduced by promoting a positive culture of compliance. Firms can do this through their tone of communication, training and the expectations that they set for their staff, as well as by ensuring that staff have the right incentives, combatting negative ideologies and publicising examples of good behaviour.

Drawing on the insights in this paper we consider a number of actions regulators can take to enhance compliance. Salient and vivid punishments are more effective at maintaining deterrence as they raise the expected costs of wrongdoing. Punishments on individuals tend to be more salient for those engaged in conducting business than are punishments at the level of the firm, and instances that individuals can relate to their own personal experience are more vivid still. Such factors can be taken into account by regulators both in their enforcement decisions and in how they choose to communicate that enforcement activity.

Regulators also have a key role in reinforcing the importance of individual morality and responsibility in decision making. The Senior Manager Regime introduced in the UK is an example of the increased focus on individual responsibility for actions that is consistent with the principles in this paper. Regulators need to consider whether compliance decisions by firms and employees are taken in a context that promotes moral reasoning rather than as part of, for example, 'tick box compliance', which risks reducing the salience of ethics in firms' decision making.

However, while regulators have their role, responsibility for compliance lies with the firm and its employees. Our paper contains a number of research-based ideas on how firms can change their culture and decision making to improve the rate of compliance. Increased awareness of how

behavioural biases affect decision making can lead firms to develop improved internal controls on decision making to reduce the effect of these biases.

It is in the areas of morality and culture that there is greatest scope for firms to act. At heart, poor culture within a firm amounts to a failure of leadership. Managers influence culture through the tone they set and their expectations of staff, including challenge of poor behaviour and of the norms and beliefs that sustain poor behaviour. There is also a responsibility to have the correct incentives, for example, to ensure that staff remuneration does not directly or indirectly promote poor conduct.

Firms can bring morality to the fore when their employees take decisions, and in ways that go well beyond the occasional training on ethics that many firms require. Positive ethical messages need to be consistent and regular so that they are salient at the point at which staff make decisions. Having staff sign up to a moral code, therefore, committing to moral standards can help to engage such moral reasoning, as can ensuring that staff engage directly with consumers to see the consequences and impact of their work. In these ways there is considerable scope for firms to improve their compliance with both the letter and the spirit of financial regulation.

Overall, the record of non-compliance with financial services regulation is sufficient to give pause for thought about whether the relevant players can do a better job of promoting compliance. We believe that collectively the ideas in this paper provide a useful basis for a strategic assessment of existing approaches to achieving compliance.

1 Overview

To be effective, regulators need to ensure that firms comply with the rules they set. Compliance in practice depends on a range of factors, including incentives, governance, controls, culture and behavioural issues. This paper considers how regulators can complement an incentive-based ‘credible deterrence’ approach with an approach that uses insights from psychology to change the way that firms make compliance decisions. This involves analysis of behavioural biases, morality, culture and social norms, which have tended to be studied in the context of consumer decision making. Their implications for compliance are less well understood. Developing our understanding of these implications is a key motivation for this paper.

Incentives and compliance in organisations

Regulators usually impose rules when firms have incentives to act in ways that are injurious to the regulators’ objectives, for instance, when a firm can exploit market power to increase the prices that consumers pay. For economic regulation to be effective, regulators need to ensure that regulated firms comply with these rules.

What determines compliance? Standard economic models suggest that a fully rational decision maker would compare the expected benefits of rule breaking with the expected costs, the latter determined by a combination of the probability of detection and the size of punishment in the event of detection. These models have had a significant influence on regulators’ approaches to compliance, with ‘credible deterrence’ tending to focus on using detection and punishment to change firms’ incentives, alongside strengthening the quality of firms’ governance and internal controls.

A credible deterrence strategy will remain a vital part of regulators’ attempts to provide appropriate incentives to improve compliance, though practical examples from economic regulation suggest that it has some limitations. For instance, widespread violations of competition law have persisted in spite of increasingly heavy penalties. If people do not always respond to incentives in a strictly rational way, a fully effective strategy will need to take this into account. Insights from psychology may, therefore, usefully supplement a credible deterrence approach.

Behavioural biases

Behavioural biases occur when people’s decision making departs from the benchmark of strict rationality.[1] Broadly speaking, such biases can affect people’s preferences, their beliefs, and the way they make decisions, all of which are important for the way that people respond to compliance incentives. Biases in preferences affect the way that people weight the costs and benefits of rule breaking, with present bias increasing the perceived benefits of rule breaking and endowment effects resulting in firms becoming excessively attached to existing, potentially poor, compliance processes.

Biases in beliefs affect what people think to be true of the world. Overconfidence, having excessive faith in one’s own abilities, can lead firms to overestimate their ability to avoid detection, or to have unwarranted confidence in their internal controls. Other biases affect the way people make decisions. Salience and vividness effects may lead firms to pay selective

[1] We not do use the term behavioural bias in any pejorative sense. In real life people’s decisions are rarely made in a fully rational way and everyone exhibits behavioural biases. In addition, even though people may not behave in ways that are rational according to a formal model, this does not mean that their behaviour is random or unpredictable. Understanding of behavioural biases can predict how people will behave and input into policy development.

attention to information on the expected costs and benefits of compliance, while groupthink can lead cohesive groups to make bad decisions, potentially leading to poor governance and controls.

Morality

External incentives to break rules, comprising expected costs and benefits, are not, however, the only determinants of rule breaking. People like to think of themselves as moral, and their actions determine the extent to which they can maintain such a view. This means that people will break rules when they can rationalise the benefits of rule breaking as being consistent with their status as a good, virtuous person. There is, therefore, a trade-off between external incentives to break rules, and internal incentives, which include rewards and punishments such as feelings of satisfaction for acting virtuously and shame for doing wrong.

Contextual factors help to determine the weight that people attach to such moral considerations, and therefore affect the interaction of people's internal and external incentives. If ethical considerations are salient when people make decisions, it is more difficult to rationalise wrongdoing. For instance, making people recall moral codes before they have the opportunity to break rules can make wrongdoing less likely.

On the other hand, a number of other factors make moral considerations less important in decision making. Being distant from carrying out rule breaking and from its effects can lead people to place more weight on external incentives and make rule breaking more likely. The London Inter bank Offered Rate (LIBOR) manipulation has many features that are characteristic of the idea that 'distance' facilitates rule breaches. Manipulation was vicarious, with one department in offending banks asking a different department to alter the rates that they submitted, while the connection between an interest rate measure and harm to consumers is not obvious, with the offenders many steps removed from the consumers that suffered as a result of the wrongdoing.

While moral considerations act as a check on wrongdoing in some situations, this can be overridden if people feel that they have absolved themselves of the need to hold themselves to higher standards. Pre-financial crisis regulation relied on the FSA assessing firms' employees' fitness and propriety, rather than firms doing this themselves. It is possible that removing responsibility for vetting staff ethics from firms constituted a form of moral licensing. Under the Senior Managers and Certification Regimes, firms have taken on more responsibility for certifying their staff as being fit and proper.

Taking a first step towards wrongdoing can make subsequent rule breaking more likely, while gradually increasing the scale of wrongdoing over time can facilitate increasingly severe infringements of rules. In a similar manner, firms may (inadvertently) facilitate wrongdoing in their staff by creating a sense of contractual obligation, thereby exploiting people's desire to avoid breaking commitments. Ambiguous or complex rules can enable people to make self-serving interpretations, allowing them to rationalise breaking the rules, while fatigue can limit people's ability to resist the 'temptation' to act in an immoral way.

Social context and group behaviour

Where firms are part of an organisation, decisions in individual firms are often taken in a group context. People behave differently according to their social situation, changing their beliefs to bring them in line with those around them - a situation referred to as 'social proof'. People also change their behaviour to gain acceptance from others. This means that being in a group has the potential to change people's beliefs, preferences and their decision making processes.

There is strong evidence of the effect of organisational culture and social norms on the likelihood of rule breaking, with factors such as the extent of disapproval among peers being a strong predictor of the likelihood of rule breaking. Experimental evidence suggests that rule breaking is contagious, becoming more widespread when people from one's own group are seen breaking rules, whereas seeing 'outsiders' cheat can actually reduce such infringements.

One way in which negative cultures are sustained is through ideologies, which provide a justification for rule breaking and take on a social dimension, becoming widespread within organisations. Examples include notions of 'ruinous competition' in firms that breach competition law, or appeals to higher loyalties, such as the 'cause' of the firm or duty to one's leaders.

The use of ideologies to justify wrongdoing can be seen in the example of collusion among NASDAQ market makers, who used a quoting convention that violated competition law and increased their margins. Such collusion was established as a social norm through an ideology that justified collusion in terms of ethics and professionalism, with failure to follow the convention being regarded as 'unethical' and 'unprofessional'.

Organisations may often motivate their staff through appeals to the greater good of the company. This may be problematic from a compliance perspective, as internal moral constraints on rule breaking are weaker when the breaches benefit people other than the decision maker, making breaches more likely. Experimental evidence suggests that this is true even when the beneficiaries are scarcely acquainted, but is even stronger when people have established a rapport.

In the case of LIBOR manipulation, wrongdoing occurred when banks' trading departments contacted LIBOR rate submitters, who altered the rates that they submitted. Rate submitters, therefore, gave incorrect rates information for the benefit of others in the company. It may also have been the case that traders created a sense of obligation by giving gifts to rate submitters, including meals in restaurants and champagne.

Changing the way firms make compliance decisions

Our analysis suggests that, in addition to incentives, governance and internal controls, behavioural factors determine the extent to which regulated firms comply with rules. Behavioural biases can affect the way people compare the expected costs and benefits of rule breaking. Morality can act as an internal constraint and limit rule breaking, depending on contextual factors. People behave differently in group situations, so organisational features drive behaviour and therefore the extent of compliance.

These behavioural considerations suggest that a 'credible deterrence' approach to compliance can be complemented with an approach that involves improving the 'choice architecture' that firms face when they make compliance decisions. This involves changing the situational factors that influence people's choices, to increase the likelihood that their eventual decision is to comply.

Behavioural biases can affect the way people compare the costs and benefits of non-compliance, leading to increased wrongdoing. Regulators can address this by changing perceptions of detection and punishment. This can involve salient and vivid detection and punishment to increase the expected costs of non-compliance, for example focussing smaller punishments on particular individuals, rather than larger punishments on large firms. This can be combined with salient and vivid communications, for instance focussing on striking or shocking examples or drawing attention to the impact of punishment for individual rule breakers.

Some behavioural biases, such as loss aversion and endowment effects can lead to ineffective governance and controls, as firms become excessively attached to existing poor practices. To reduce rule breaking that occurs as a result of these biases, firms can consider the use of internal scrutiny and decision tools to de-bias their decision making.

As the way that people respond to external incentives depends on the role that moral considerations play in decisions, firms and regulators can take steps to increase compliance by enhancing this. Firms can reduce rule breaking among their employees by having them commit to abide by moral codes, and subsequently using reminders to ensure the salience of this commitment. Further, firms can reduce rule breaking by drawing the attention of their staff to the consequences of their non-compliance for consumers. Regulators and firms can identify when rule breaking is more likely to occur by determining in which firms morality plays a reduced role in decision making and can facilitate an enhanced role for morality by avoiding ambiguous rules or tick-box regulation or compliance, and ensuring rules engage employees' moral reasoning.

A further insight from psychology is the role that social context plays in driving individuals' behaviour. This means that firms and regulators can take steps to improve culture to reduce rule breaking. Firms can promote a positive culture through their tone, training and the expectations that they set for their staff, and by enhancing the role of morality in individual employees' decision making. They can avoid negative culture by ensuring staff remuneration does not promote poor behaviour. Firms and regulators can promote a positive culture by combatting prevailing ideologies that trivialise poor behaviour, while regulators can influence perceptions of prevailing cultures by identifying and promoting examples of good behaviour.

2 Incentives and compliance in organisations

Effective economic regulation relies on securing compliance on the part of regulated firms. When regulators impose rules, this is usually because firms have an incentive to act in a way that harms the regulator's objectives, which in the FCA's case include securing consumer protection, promoting competition in the interest of consumers and enhancing the integrity of the UK financial system. Achieving compliance has tended to focus on how regulators can change firms' incentives through credible deterrence, particularly by detecting and punishing rule breaking firms, and on strengthening firms' governance and internal controls. Lessons from psychology suggest that in some circumstances people do not respond to such incentives in a strictly rational way. This means that, in addition to changing firms' incentives through detection and punishment, improving compliance also depends on changing the way firms make choices in response to these incentives. This chapter considers the incentives that firms face, how their status as organisations affects decision making, and what evidence suggests about how firms make decisions in response to these incentives.

Determinants of compliance

Standard economic models see regulation as a principal-agent problem, in which the regulated firm – the agent – may have an incentive to act in a harmful way.[2] The firm has private information that the regulator – the principal – cannot access, which limits the regulator's ability to prevent the firm from doing harm.[3] The sorts of harm that are of concern to regulators include the exploitation of vulnerable consumers, market integrity issues and market failures, which occur when profit-maximising behaviour on the part of firms reduces the welfare of society as a whole, for example when market power enables firms to over-charge consumers. Particular types of harm are relevant in financial services markets. For example, retail financial products and services, such as insurance and investments, are often complex, and consumers can display biases in their behaviour that lead to competition problems.[4]

To reduce such harm, regulators seek to influence firms' behaviour by imposing rules and giving firms incentives to follow them. Rules range from precise instructions, such as mandatory disclosure of particular information when selling a product, to high level rules or principles, such as a general requirement to treat customers fairly. They also include rules that allow regulation to function, such as requirements to pay fees or complete forms. Drawing up rules to regulate financial services is complicated by the need to balance the stability and soundness of the financial system with the benefits that potentially disruptive financial innovation can bring.[5]

Given that regulation is generally required when firms have an incentive to act in a harmful way, simply writing a regulation requiring them to change their behaviour is unlikely to be effective. Instead, securing compliance has generally focussed on changing firms' incentives, through detection and punishment, and ensuring firms have adequate governance and internal controls.

[2] See, for example, Laffont and Tirole (1993)

[3] Clearly in many contexts, the interests of the principal and the agent, the regulator and the regulated firm, are aligned. For example where the firm thrives by providing a good quality product to its customers.

[4] Erta et al (2013)

[5] Mehran and Mollineaux, p8-10

Changing firms' incentives

Regulators seek to change firms' incentives by monitoring their compliance and punishing rule breakers. For example, the FCA supervises firms' behaviour and business models, in part to monitor their compliance with its rules. When rule breaking is detected, the FCA can pursue enforcement cases against individuals and firms, and has a range of punishments that it can impose. This is intended to penalize those that break rules and deter others from engaging in similar actions.

Economic models of firms' compliance decisions developed from analyses of individual decision making in the field of rational crime. The model involves the firm comparing the expected costs and benefits of breaking the rules. If the expected benefits of rule breaking, relative to the benefits of being compliant, outweigh the expected costs, firms will break the rules. If the expected costs outweigh the expected benefits, they will comply with the rules.[6] In other words firms will break rules if:

benefits of rule breaking > probability of detection x punishment

When judging potential costs, firms take into account the probability of getting caught and the nature, size and speed of the punishment if they are caught. The more likely rule breaking is to be detected, and the more severe the penalty for infringing the rules, the less likely rule breaking is to take place, at least in this framework.

For example, a firm may consider joining an illegal cartel and gaining higher profits. This framework says that they will compare the expected benefits of the cartel with the expected costs of being punished. Suppose that the firm will earn an additional £1 million of profit if they join the cartel, while the fine if the firm is caught is £10 million. If the probability of being caught is 5%, then the expected cost of rule breaking is £500,000 which is less than the £1 million benefits so the firm will join the cartel. On the other hand, if the probability of being caught is 20% then the expected cost of rule breaking is £2 million, so the firm will not join the cartel.

The goal of regulatory enforcement is to improve compliance with rules. According to this framework, regulators should be able to increase compliance by making the detection of rule breaking more likely, for example, by increasing the intensity of their supervision activities or giving incentives to whistle-blowers, or by increasing the severity of their punishments, for example, by imposing higher fines. While it might first appear that the best way to discourage rule breaking is to have the most severe punishment in all circumstances, this is not the case. This is because it removes any marginal deterrence for more serious rule breaches. For example, if thieves face execution for stealing £5 then they may as well steal £5 million.

This account of firms' compliance incentives has had a significant impact on how most regulators think about credible deterrence, and is implicit in many approaches to improving compliance. For example, a recent report by the International Organization of Securities Commissions (IOSCO) on credible deterrence suggests a number of ways in which regulators can use the probability of detection and the size of punishments to make deterence credible.[7] Factors relating to the probability of detection include ensuring that regulators are well connected with markets and have the right information, and on regulators collaborating to share information and eliminate safe havens. Punishment for rule breaches can be enhanced by rigorously and swiftly investigating and prosecuting misconduct and imposing sanctions that are effective, proportionate and dissuasive. Some factors affect both the probability of detection and the size of punishment, such as the quality of the legal and regulatory framework.

[6] Becker (1968)

[7] IOSCO (2015)

Governance and controls

Corporate governance refers to the process by which companies are controlled and directed. Governance, as distinct from the day to day management of the company, is intended to ensure that the company is well run and follows laws and regulations. Boards of directors have key responsibility for firms' governance and provide independent oversight, reviewing key decisions concerning firms' strategy, risk appetite, organisations and internal controls.[8] Therefore, firms' boards have an important role in ensuring that firms achieve compliance with regulation. They are intended to have an appropriate range of skills and experience to discharge these duties.[9]

Boards do this by ensuring the adequacy of firms' internal controls. These are the mechanisms by which firms manage their risk, including those associated with non-compliance. These controls include various 'lines of defence'. The first line of defence refers to the role of management controls in the day to day operation of the business; the second line of defence refers to oversight functions, such as risk aggregation, within the firm; and the third line of defence is the firm's internal audit function. Boards are not directly involved in implementing these controls, but are intended to oversee their proper functioning.

Taken together, incentives, governance and internal controls reinforce each other. Changing firms' incentives and making compliance more appealing than rule breaking clearly makes it important for boards to ensure that their controls are adequate.

Compliance in organisations

As organisations, firms are not single unitary entities. The economic theory of the firm suggests that we can think of the firm as a network of social relationships, which tend to involve principal-agent situations in a context in which there is imperfect monitoring.[10] The most important relationships within firms are those between junior and senior employees, shareholders and the board of directors. As a simplification, we can think of senior employees as making decisions about the actions that firms will take, whereas junior staff carry them out. Shareholders 'own' the firm, in the sense that they are entitled to what remains once employees and creditors have been paid, and exercise control in the sense that they can usually dismiss the most senior staff. However, they often have limited involvement with the day to day running of the firm. As set out above, boards are responsible for governance, providing oversight of how the firm is run.

This means that deliberate rule breaking could take place in a number of ways. Rule breaking could occur as a result of decisions by senior staff, making it company policy to break rules and ordering junior staff to do so. Senior staff could make these decisions of their own accord, for example, if their salaries were linked to company performance and they thought that rule breaking would improve company performance,[11] or shareholders could induce senior staff to act in this way by threatening to reject their reappointment. Rule breaking could also occur if junior employees decided to break rules without explicit instruction from senior staff, for example, if they thought that it would improve their performance and therefore their chance of promotion. Given the principal-agent nature of these relationships, decisions to break rules could occur against the wishes of shareholders or senior staff. In all cases, such rule breaking involves a failure of internal controls and of governance.

In addition to monetary incentives, reputation, meaning a desire to advance one's standing in the eyes of one's audience, can also drive people's behaviour.[12] Firms and individuals therein are concerned about their standing with their networks of audiences, which include regulators,

[8] Mehran and Mollineaux (2012) p13

[9] Financial Reporting Council: The UK Corporate Governance Code

[10] See, for example, Alchian and Demsetz (1972) and Fama (1980), which see the firm as a network of contracts between individuals, involving principal-agent situations in which there is imperfect monitoring. The former considers the role of team production, which makes it difficult to monitor individuals' contribution to total firm output. The latter emphasises the separation of management and risk bearing, which results in incentive problems for managers in firms.

[11] See for example the discussion in Heady and Myles (2016).

[12] Busuoic and Lodge (2015)

potential employers, competitors and consumers. While in the principal-agent view firms' private information is a benefit that they would not wish to give up, the reputational view suggests that they might do so if it enhanced their standing with their audiences. The way in which firms respond to compliance incentives will also be subject to reputational considerations, as being seen to have engaged in wrongdoing is likely to affect firms' and individuals' standing with the audiences. Within this framework, reputation damage could feature as an addition to punishment in the event that wrongdoing is detected. Alternatively, if wrongdoing is known to actors other than the regulator, reputational damage could be thought of as reducing the benefits of rule breaking.

Shareholders

We normally think of shareholders as 'owning' the firm, in the sense that they are the ultimate beneficiaries of the profits that the firm makes. This suggests that shareholders have the most to gain and lose from rule breaking, as their stake in the firm is actually the riskiest, for example, compared to staff that are paid salaries or the company's debt holders. While at first sight this might suggest that shareholders should have an incentive to reduce company risk, including the risk of incurring penalties from rule breaking, in practice this incentive is limited. This is because shareholders can diversify their portfolios of investments, thereby limiting their company-specific risk.[13] Further, agency problems in firms' capital structures may mean that shareholders can transfer risk to a firm's debt holders.[14] This suggests that shareholders could have the most to benefit from rule breaking, alongside a higher risk appetite and little incentive to rein in such behaviour. Although they often have little involvement in the day to day running of the firm, shareholders also have a number of mechanisms available to them to overcome principal-agent problems and induce staff to behave in accordance with their interests.

Board of directors

As set out above, as boards have direct responsibility for ensuring that internal controls are adequate, they are likely to have strong reputational concerns to ensure that firms are compliant. On the other hand, boards have a duty to shareholders to maximise the value of the company and are often remunerated according to company performance. This means that there could be some incentive for boards to 'turn a blind eye' to poor controls in some cases.

Senior staff

Concern over principal-agent problems within companies has generally focused on the potential for management to pursue their private interests at shareholders' expense. For example, senior employees could use company resources for corporate perks or engage in empire building to enhance their own prestige. To address this concern, a common response has been to attempt to align the incentives of shareholders and senior staff by paying the latter in shares, rather than cash.[15] While payment in shares may help to overcome principal-agent problems, if successful it would also increase senior employees' benefit from rule breaking. On the other hand, senior staff are more likely to have reputational concerns that will mitigate their willingness to take such risks.

Junior staff

If senior employees are overly optimistic about the benefits and costs involved in rule breaking they are also in a better position than shareholders are to instruct junior staff to carry out the relevant violations and ensure that they take place. Senior staff can also use their ability to set junior employees' pay to mitigate principal-agent problems and reward employees that act in

[13] Haldane (2015)

[14] Jensen and Meckling, 1976, p335-7. In Jensen and Meckling's example, the owner of a firm can issue debt to naïve bondholders, then decide on the firm's projects and then sell some proportion of the remaining equity. By promising to undertake a low risk project, issuing debt and then choosing a riskier project, the owner can transfer value from debt to equity.

[15] Haldane (2015) p10

accordance with their wishes, though of course this mechanism is not perfect and it is unlikely that senior staff can monitor all actions of junior employees. Junior staff are also likely to have fewer reputational concerns than senior staff.

Compliance, deterrence and behaviour

In practice regulators recognise that a broad range of factors matter for compliance. IOSCO recommends sending strong public messages and promoting public understanding and transparency as part of a credible deterrence strategy, in addition to regulators ensuring that they evaluate and revise their own governance, strategy, priorities and tools. Likewise within legal and regulatory theory there is a broad literature on the interaction of culture with compliance. Regulators have, nevertheless, tended to focus their attention on improving firms' governance and controls and increasing the certainty and severity of punishment and monitoring. For example, of the seven factors that IOSCO identifies as underpinning credible deterrence, five relate either to the certainty or severity of punishment.[16]

While these are without doubt important components of a credible deterrence strategy, there is strong evidence to suggest that we need also to take into account insights from psychology on the potential for people to display 'behavioural biases'. Such biases occur when human thought and behaviour depart systematically from the strictly rational framework that informs much economic analysis. The term 'bias' is not necessarily pejorative; it can also refer, for example, to useful mental shortcuts that aid quick decision making. The FCA's Occasional Paper 1 set out how these biases lead consumer behaviour to depart from the predictions of traditional economic models.[17]

Some studies have found that increasing the probability of detection is more effective at discouraging rule breaking than increasing punishments. The effectiveness of increasing the probability of detection also depends on the nature of the infringement, tending to be more effective for rule breaches such as tax evasion and fraud than violent crimes.[18] Some evidence from behavioural experiments has called into question the effectiveness of both certainty and severity. These experiments suggest that people tend to break rules by a modest but consistent amount, regardless of the level of reward or the probability of detection.[19] In fact, some experiments have found that people cheat less when the possibility of gain is higher.[20]

Practical examples from economic regulation also suggest that there could be valuable insights from psychology. For example, there is some evidence that increasing fines and the likelihood of detection for cartels in the United States has not reduced rule breaking.

[16] The seven factors are that regulators should: enhance the quality of legal and regulatory frameworks to provide legal certainty; detect misconduct by being well connected and getting the right information; co-operate and collaborate to eliminate safe havens and work together; rigorously and swiftly investigate and prosecute misconduct; impose sanctions that are effective, proportionate and dissuasive; send strong public messages, and promote public understanding and transparency; and evaluate and revise enforcement governance, strategy, priorities and tools.

[17] Erta et al (2013)

[18] Entorf (2012)

[19] Ariely (2012) p17-21

[20] Ariely (2012) p17-19

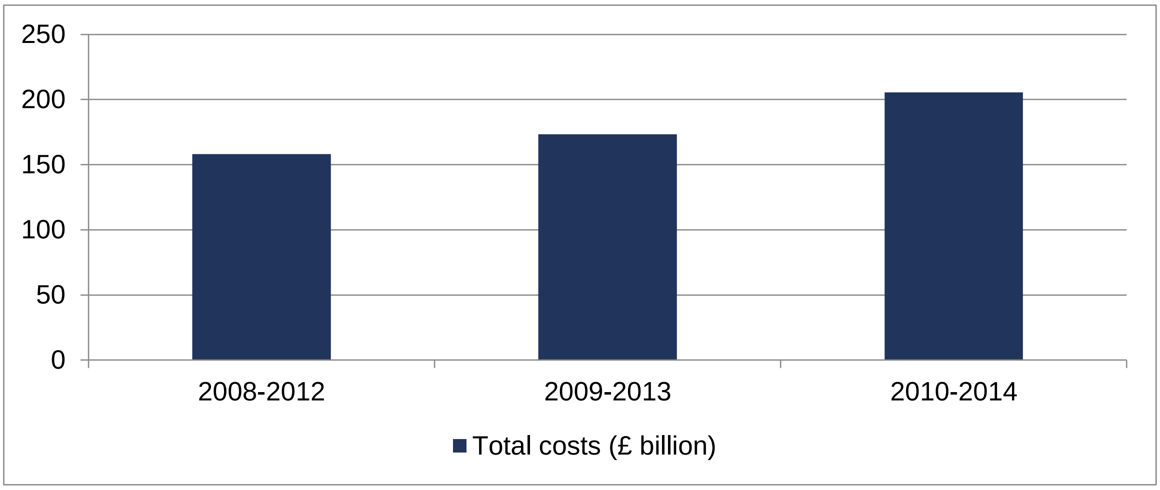
Deterring poor behaviour

Cartel deterrence in the United States

Beginning in the 1970s, the United States introduced increasingly heavy penalties for breaching competition law, incorporating individual executive accountability and high corporate fines. This includes prison sentences of up to 10 years, individual fines of up to $1 million and corporate fines of up to $100 million or twice the gain or loss caused by the cartel. To increase the likelihood that cartels would be detected, the United States introduced a leniency program, enabling firms and individuals to avoid punishment by being the first to confess to violations of competition law.[21] However, there is little evidence that higher penalties and a higher likelihood of detection were successful in deterring cartel activities. The duration of cartels did not fall, even though the likelihood of detection increased. Moreover, in spite of higher fines and prison terms, reoffending remained common and major cartels continued to operate even after major fines were imposed on other price-fixers.[22]

In the context of financial regulation, there is evidence to suggest that in the early to mid 2000s a perception that rule breaches would go undetected or unpunished led to rule breaking, including benchmark manipulation, in some fixed income, currency and commodities markets. In particular, individuals' language in electronic communications suggests that they did not expect wrongdoing to be identified by the firms' management or compliance departments, or external supervisors.[23] Since the financial crisis, the FSA and then the FCA have adopted a more forceful approach to deterrence, with large increases in fines in particular, amounting to £1.5 billion in 2014. This has been replicated internationally, with fines and similar costs associated with banks' conduct across the world estimated to be £206 billion for the years 2010-2014.[24] Fines have increased even in jurisdictions that already imposed large penalties. For example, US Securities and Exchange Commission's penalties and disgorgements have increased from £3.1 billion in 2012 to $4.2 billion.[25]

Figure 1: Total costs associated with fines and firm conduct incurred by banks



Source: CCP Research Foundation

It is too early to determine the extent to which these large punishments for violating financial regulation are effective in reducing rule breaking. Given the apparent perception among firms that punishment was unlikely to occur at all, it appears that the fact of higher punishment will have had

[21]Stucke. 2011, p264-266

[22]Stucke. 2011, p268-269

[23] HM Treasury, Bank of England and FCA (2015) p84

[24] CCP Research Foundation

[25]https://www.sec.gov/news/pressrelease/2015-245.html, https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370543184660

some deterrent effect. The evidence that we have suggests that there are limitations on the extent to which greater compliance can be achieved by increasing fines and the probability of detection. For example, there is a tendency of certain firms to carry on breaking rules in spite of continuing to accrue large fines. The FCA fined Barclays £59.5 million in 2012 for breaches in relation to LIBOR fixing, £38 million in 2014 for putting client assets at risk, £284 million for forex failings in 2015, and £72 million for poor handling of financial crime risks in 2015.

Conclusion

Regulators' attempts to improve the compliance levels of regulated firms have tended to focus on enhancing firms' incentives to comply by detecting and punishing infringements, and strengthening firms' governance and internal controls. While regulators recognise the broad range of additional factors that affect such decisions, including reputation and culture, much of their focus has been on improving incentives to comply by increasing the probability of detection and the size of punishments that firms face. Although these are important components of a credible deterrence strategy, there is evidence to suggest that we also need to take into account lessons from psychology on how people make compliance decisions. This includes how behavioural biases can affect decision making and behaviour, the role of morality in decision making and the influence of social context on compliance. The remainder of this paper goes on to consider these insights, before setting out the implications for firms and regulators seeking to improve levels of compliance.

3 Behavioural biases and compliance decisions

The evidence we examined in the previous chapter suggests that people do not always respond to compliance incentives in a strictly rational way. This implies that an effective compliance strategy needs to take into account how people make compliance decisions in response to these incentives. Research in the field of psychology has studied how behavioural biases affect people's decision making. This chapter considers how such biases can affect decision making within firms, particularly with respect to assessments of the costs and benefits of rule breaking and the controls that firms have in place to minimise such rule breaking.

Behavioural biases in organisations

The FCA's Occasional Paper 1 set out how behavioural biases can affect consumers' decisions. Despite the evidence on deterrence in the previous chapter, it might at first appear that the scope for such biases to affect firms is less than it is for consumers, and that insights from psychology would be less relevant for organisations than for individuals. Firms selling to large numbers of customers have more incentive to make the right decision, and the opportunity through repetition to learn how to do so. Individual consumers, on the other hand, may only infrequently need to make such important decisions, particularly about financial services products. Unlike consumers, firms compete with each other and bad decisions can lead to their failure.[26]

There are, however, good theoretical reasons to think that firm behaviour could still be susceptible to behavioural biases. Whereas consumers are challenged when they face a choice between complex products, firms have to develop products that consumers will value, at a price that is competitive and delivers an appropriate return. This has to be assessed in a situation of uncertainty over how consumers will react to the offering and how rivals may respond. These additional complications to decision making can introduce more points at which biases could make their effects felt.

Firms may be able to use their organisational structure and expertise to mitigate the effects of behavioural biases, as it is easier to identify biases in others than it is in oneself. This tendency known as the 'bias blind spot', may be due to people placing more value on introspective information relative to behavioural information when considering themselves than they do when assessing others'.[27] This means that organisations may be able to structure themselves in a way that identifies biases in their employees and mitigates their effects.

On the other hand, there are reasons to be sceptical of the practical effectiveness of firms' organisational structures in reducing biases, as biases may also have influenced the design of these structures and affect the operation of the processes within them. There are also limits to the extent that expertise limits behavioural biases. Indeed, some research suggests that rather than mitigate the bias blind spot, cognitive ability may in fact be associated with a larger blind spot.[28] Further, these biases could be exacerbated by the fact that individuals may themselves behave differently in a group context.

The FCA's Occasional Paper 1 set out how we can think of behavioural biases as affecting preferences, beliefs and decision making. Maintaining this classification, the remainder of this chapter considers how behavioural biases can affect firms' compliance decisions. In the previous chapter we described how the extent of rule breaking depends on the incentives facing staff at

[26] Armstrong and Huck (2010), p5-8

[27] See Kugler and Pronin, 2007

[28] See West, Meserve and Stanovich, 2012

different levels in the organisation and controls within the firm. We discuss how behavioural biases can affect incentives to break rules, focusing on the probability and severity of detection, and how they can affect the internal controls and governance procedures that are supposed to guard against such rule breaking. We summarise the main findings of this chapter in the table below.

Table 1: Behavioural biases and their effects on compliance decisions

Bias affects	Bias	Description	Result
Preferences	Present bias	Time inconsistent preference for something now rather than later	Increase in perceived benefits of rule breaking
Preferences	Endowment effects and loss aversion	People value something they have more than something they do not	Excessive attachment to existing (possibly poor) compliance processes
Preferences	Omission bias	People favour omissions to commissions	Perceived benefits of rule breaking higher for omissions than commissions
Beliefs	Overconfidence	Excessive faith in one's own abilities	Reduction in perceived likelihood of detection; unwarranted faith in compliance processes
Beliefs	Confirmation bias	People interpret evidence in accordance with their prior beliefs	People make self-serving interpretations of rules
Decision making	Salience, vividness	Attention selectively drawn to salient and vivid information	Judgements are made on subset of available information
Decision making	Groupthink	Cohesive groups make poor decisions	Firms have poor internal compliance processes

Preferences

Some biases affect what people want, as emotions and psychological experiences alter their preferences.[29] By altering people's preferences, such biases can change the way they respond to incentives, particularly how they make trade-offs between the gains to be made by breaking rules and the potential costs.

For example, while it can be perfectly rational to prefer to have something now rather than later, present bias occurs when this preference is inconsistent across time.[30] For example, a firm would display present bias if it preferred to make a £500 sale today rather than a £550 sale tomorrow, but preferred a £550 sale in 101 days' time to a £500 sale in 100 days' time. When firms make decisions over whether to comply with rules, the benefit from breaking rules is usually more immediate than the uncertain future punishment. For example, mis-selling products to consumers can generate large initial profits, but carries the possibility of significant fines and compensation claims at a later stage.

[29] Erta et al. 2013 p15

[30] Brest and Krieger, 2010 p413

Present bias is, therefore, likely to increase the perceived benefits of rule breaking. Whether this results in breaches will depend materially on the incentive structures within firms. For example, even if shareholders are present biased, this may only result in rule breaking if staff compensation also displays the same features of large initial benefits and uncertain future costs.

Other biases can affect people's preferences over the nature of the benefits and costs of rule breaking. Omission bias refers to the tendency to prefer omissions to commissions that have exactly the same effect, for example, a firm that fails to pay a supplier may see itself differently to one that actively steals goods. This bias could affect the types of rules that firms comply with, meaning that firms are less likely to violate rules that prohibit the commission of specific acts and are more likely to violate rules that require them to act in specified ways.

Behavioural biases could affect how firms assess their controls and governance structures. Endowment effects mean that people value something that they own more than something exactly equivalent that they do not own, so that the act of possession or involvement creates its own value. This is related to the general tendency of people to prefer avoiding losses to acquiring gains, known as loss aversion.[31] A person exhibiting loss aversion might prefer a situation in which they had £10 and lost £2 to one in which they had £15 and lost £5, even though the end result is that they have less money. It may be that people are particularly prone to engage in wrongdoing for the sake of recouping perceived losses, rather than setting out to achieve large gains from misbehaviour.[32]

Endowment effects and loss aversion apply to both tangible and intangible objects, so can lead people to become overly attached to their past decisions.[33] Similarly endowment effects could affect compliance through their impact on firms' governance and controls. Existing firms will generally have established governance processes and internal controls. To ensure that they maintain the quality of such processes, firms need to keep them under review. Loss aversion and endowment effects could lead firms to be excessively attached to their existing approaches, even when they may not be the best way to achieve compliance.

Beliefs

Other biases affect what people believe to be true. Overconfidence refers to the tendency to believe that one's skills and knowledge are better than they really are. For example, a survey in 2013 found that 65% of senior bankers believed that there were significant cultural problems in their industry, but only 33% thought that there were such problems in their own bank.[34] This can lead potential rule-breakers to have excessive faith in their ability to benefit from breaking rules and their ability to avoid detection.[35] There is also a well-documented tendency to believe that low probabilities of gains are higher than they really are.[36] In addition, even where firms intend to comply with rules, overconfidence can lead boards of directors to have unjustified confidence in their systems and controls, leading them to give insufficient scrutiny.

Within organisations, there are good reasons to expect that overconfidence could affect senior staff in particular, leading them to be over-optimistic about benefits of rule breaking and its chances of going undetected. To progress from being junior to senior, employees need to be high performers. In reality, performance is likely to be a combination of skill and luck. If employees can choose to engage in riskier projects then the best performers will include employees that were most optimistic and took the greatest risks. Senior staff will then tend to be skilled, lucky optimists with a high tolerance of risk.[37]

[31] See Kahneman and Tversky, 1984

[32] Rick and Loewenstein, 2008, p645

[33] Kahneman, 2011, p9

[34] Deloitte, 2013, p2

[35] Stucke, 2011, p270-1

[36] Entorf, 2012

[37] Armstrong and Huck, 2010, p46

Confirmation bias occurs when people seek evidence that supports their prior beliefs and ignore or belittle evidence that contradicts them.[38] This can manifest itself in a number of ways, such as selectively evaluating and interpreting information to favour prior beliefs. Alternatively, people may treat information that conflicts with their prior beliefs as exceptions, increasing confidence in their own beliefs in the process of explaining away contradictory information. Further, people can find it difficult to find alternatives to their prior beliefs, even when these beliefs have been shown to be wrong.[39]

Confirmation bias could reinforce the tendency of individuals within firms, particularly senior staff, to be overconfident. In addition, rules cannot prescribe precisely how firms should act in every situation, so will inevitably be ambiguous in some circumstances. Regulators use rules to attempt to correct firms' private interests and these incentives remain when firms read and interpret ambiguous rules. Confirmation bias can encourage firms to interpret regulations in a way that most accords with their private interests, selectively reading rules and ignoring evidence that contradicts this reading.

Decision making

A different set of biases affects how people make decisions and how they take information into account. Information that is 'salient' stands out strongly against other available information. For example, an aeroplane crash is salient in a way that a car crash is not.[40] Vivid information presents an engaging story, for example, about personal experiences.[41] Information is more likely to be vivid if it provokes emotional interest, if it uses concrete, emotionally gripping information, or if it involves direct personal experiences.[42] This is related to a mental shortcut known as the availability heuristic, which refers to the tendency to make judgements on probability and causation based on how readily relevant examples come to mind.[43] This can lead people to overestimate the likelihood of rare but attention-grabbing events.

This means that firms may make judgements about the severity and certainty of punishment for rule breaking on the basis of a subset of the available information. This can lead them to overestimate the likelihood of detection in areas in which they can recall that it has occurred and underestimate the likelihood of detection in other cases. Decision making biases may also lead to inadvertent non-compliance if firms pay attention to some rules at the expense of others.

One feature of organisations is that they often make decisions in groups. Groupthink occurs when cohesive groups prematurely coalesce around poor decisions. Such groups have excessively optimistic views of their own skills, knowledge, power and moral righteousness, and also tend to be closed minded.[44] This can lead firms to have poor internal controls and governance procedures, thereby increasing the likelihood of rule breaking.

[38] Brest & Krieger, 2010 p278
[39] Brest & Krieger, 2010 p279
[40] Choi & Pritchard, 2003 p15
[41] Hirshleifer, 2008 p858
[42] Brest & Krieger, 2010 p258
[43] Tversky and Khaneman, 1973 p207-209
[44] Brest & Krieger, 2010 p601-2

Social dynamics

Groupthink

In the lead up to the failure of HBOS, despite its significant collective business experience, HBOS's board of directors gave insufficient challenge to the firm's strategy and paid too little attention to risk.[45] Some of the board's decision making shows features of groupthink. For example, directors often came to consensus views in advance of board meetings, meaning that there was insufficient debate and directors were not aware of their colleagues' concerns.[46] One particular feature of groupthink is the tendency of groups to unite around a position, giving it insufficient scrutiny. In HBOS board meetings, there is some evidence to suggest that discussion was limited by the fact that the chairman would signal his agreement or disagreement with proposals in advance of the board debating them.[47]

Conclusion

There are good reasons to believe that behavioural biases can affect firms' compliance decisions. These biases affect people's preferences, their beliefs and the way they make decisions, both individually and in groups. Biases affecting preferences include present bias, which can lead to time-inconsistent preferences, thereby increasing the perceived benefits of rule breaking, and endowment effects, which can result in excessive attachment to existing poor governance processes. With respect to people's beliefs, overconfidence can result in people having excessive faith in their ability to avoid detection and unwarranted confidence in their firms' internal controls. Salience and vividness effects can result in people paying selective attention to information in their decision making. Groupthink can lead firms to make poor decisions, leading to poor governance processes.

[45] PRA and FCA (2015), p29
[46] PRA and FCA (2015), p203
[47] PRA and FCA (2015), p213

4 Morality and rule breaking

The expected costs and benefits of rule breaking are important determinants of firms' compliance, and thinking about how to improve firms' behaviour has generally concentrated on how to affect firms' incentives by changing these costs and benefits. This is unsurprising, as regulators have obvious mechanisms to influence these incentives through detection and punishment. Nevertheless, they represent only one dimension of decision making over compliance. In addition to these 'external' incentives, moral considerations can also affect decisions over compliance. This chapter examines the role of morality in decision making, and how it interacts with the external costs and benefits of rule breaking to determine whether breaches occur.

Morality and internal incentives

So far we have considered how behavioural biases affect people's assessments of the costs and benefits of rule breaking and of the governance processes that are intended to minimise rule breaking. Although this can explain why firms break rules in spite of regulators increasing their monitoring efforts or the punishment they give firms, it cannot explain situations in which people do not break rules in spite of a low probability of detection or low punishment.[48] To explain this, we review insights from psychology on how moral considerations can affect decision making.

People like to think of themselves as moral, and their actions determine the extent to which they can maintain this view of themselves, known as their 'self-concept'.[49] This means that, in addition to external incentives, such as punishments from regulators or gains from rule breaking, decision makers also receive internal rewards for virtuous behaviour and punishments for bad behaviour. for example, feelings of satisfaction for doing good and feelings of shame for doing wrong.

This internal conflict between incentives to break rules and the desire to see oneself as a moral person can dampen decision makers' sensitivity to the external incentives.[50] People break rules when they can rationalise gaining the benefits of rule breaking as being consistent with their own virtue.[51] This potential for self-deception may be related to the bias blind spot. The trade-off between internal and external incentives depends on contextual factors, which determine the weight that decision makers attach to moral considerations. The mechanisms that allow people to maintain a moral view of themselves have been referred to as the 'fudge factor'.[52] The table below describes how such factors affect the interaction between internal and external incentives.

Table 2: Factors affecting interaction between internal and external incentives

Factor	Description	Example
Salience of ethics	When ethical considerations are not salient, rule breaking is more likely.	Making people recall moral codes before they engage in an activity makes them less likely to break rules.
Distance from rule breaking	Distance from carrying out rule breaking or its effects makes rule breaking more likely.	Executives may be distant from the effects of rule breaking on consumers and from carrying it out in their

[48] Ariely. 2012

[49] Mazar, Amir & Ariely, 2008, p633-4

[50] Mazar and Ariely. 2006, p4-6

[51] Ariely, 2012, p27

[52] Ariely, 2012

Factor	Description	Example
		firms.
Moral licensing	People are more likely to break rules if they feel moral considerations no longer apply.	Disclosing a conflict of interest can make people more likely to exploit the conflict of interest.
First steps and small steps	Taking an initial step in breaking a rule makes subsequent rule breaking more likely. Increasing the magnitude of rule breaking little-by-little can lead to more severe infringements than one large step.	Having already violated a particular moral consideration, individuals are less inhibited making subsequent violations. By increasing wrong-doing by small amounts, individual increases do not appear material even though the end result is significant.
Contractual obligation	Creating a sense of contractual obligation.	Making employees feel as though they had already agreed to engage in rule breaking.
Ambiguity and complexity	Ambiguity and complexity can make rule breaking easier to justify.	Unclear rules permit self-serving interpretations.
Fatigue	Being tired increases the likelihood of giving in to external incentives and breaking rules.	People are more likely to cheat having undertaken strenuous mental tasks.
Roles	Giving rule breakers meaningful roles with positive values facilitates rule breaking.	Price fixers are perceived as respectable members of society until prosecuted.

Salience of ethics and distance from rule breaking

Salience of ethical considerations

If people make compliance decisions by rationalising the pursuit of self-interest with the decision maker's sense of his or her own ethics,[53] increasing the salience of ethical considerations can make it more difficult for people to reconcile their rule breaking with their moral status, thereby increasing compliance with rules. For example, experimental research found that people cheated less when they were first asked to recall the Ten Commandments and when they first signed up to a code of honour.[54] Honour codes have also been found to be associated with reduced incidences of cheating in academic institutions, and that students that signed honour codes were less likely to rationalise the cheating that they admitted to committing.[55] Similarly in situations such as filling in insurance policy forms and tax returns, in which people are asked to sign to say that they have truthfully report facts about themselves, signing before filling in the form reduces dishonesty by raising the salience of ethical considerations.[56]

Distance from rule breaking

Distance from both carrying out rule breaking and its impacts can make infringements easier to justify. If we break rules, it is easier to see ourselves as still being moral people if we are further

[53] Of course what one person considers to be ethical may be considered unethical by someone else. So the content of the ethical code matters in these contexts, as indicted in the NASDAQ example in Section 1 of this paper.

[54] Marzar, Amir and Ariely (2008) p635-7

[55] McCabe, Trevino and Butterfield (2001) p226

[56] See Shu, Mazar, Gino, Ariely and Bazerman (2011)

from the act of carrying it out and the negative impact it has on others. Even putting a small amount of distance can have a large effect. In experimental research, people cheated more when the gains of cheating were in the form of tokens that could be exchanged for money than when cheating generated cash directly, even though the end result was the same.[57] Further, creating distance from carrying out acts of wrongdoing by denying responsibility and from the effects of wrongdoing by denying the injury that it imposes, is often observed as a tactic by which those involved in corruption rationalise their participation and continue to believe that they are ethical people.[58]

In the context of financial services, firms' employees' work may be many steps removed from their effect on end consumers, which could increase the likelihood of rule breaking.[59] For example, in wholesale markets the negative consequences of rule breaking may appear to be numbers on a screen, even though they can have large impacts on end consumers. Even for some firms dealing with retail customers, it may be that only a modest proportion of staff actually interacts with the end customers that would ultimately be affected by wrongdoing. In addition, even though individual rule breakers within firms are likely to benefit from rule breaking through higher pay or bonuses, this occurs indirectly as the initial beneficiary of rule breaking is their employer. Similarly, some cases of rule breaking such as cartel formation, involve a number of firms or individuals making a collective decision to break rules, so responsibility for the negative consequences of rule breaking is shared.

Distance from rule breaking

LIBOR manipulation

LIBOR is an interest rate measure calculated as the average interbank rate at which major London banks lend to each other. The rate is an important measure used by many financial institutions, with large numbers of financial contracts based on the measure. The rate is calculated using submissions from the banks in question, which are supposed to be the actual interest rate the banks pay. As the rate is a benchmark across a large number of financial products, the banks had a conflict of interest as the rates they submitted could affect the profitability of their trades. As a result, banks artifically increased or decreased the rates that they submitted to profit from this. In the wake of the scandal, significant reforms were made to the benchmark following the Wheatley Review.

It is likely that the size of the scandal and the extent of wrongdoing were influenced by the nature of the mechanisms through which manipulation and the resulting damage took place. Manipulation occurred vicariously, as trading departments requested LIBOR submitters to alter their rate up or down. Further, the rate itself is simply a measure of interest rates, so the connection with harm to consumers was unlikely to be obvious to the submitters. The mechanism through which harm accrues to consumers is contracts that use LIBOR as a benchmark. The harm was so many steps removed from the traders who requested manipulation it is likely to have encouraged more extensive wrongdoing.

Within organisations, this distance can be increased when responsibility for rule breaking is dispersed. This could be, for example, because people at the top of the organisation make the decision to break the rules, but the rule breaking itself is carried out by subordinates.[60] Shareholders are distant from the carrying out of any rule breaking done for their benefit, so the internal incentives that restrict rule breaking may be diminished. While senior staff may be closer to the act of rule breaking than junior staff, there is likely to remain some distance between them and their wrong-doing, thereby dulling internal incentives for good behaviour. As junior staff are likely to have to carry out any rule breaking, they may have stronger internal incentives to guard

[57] Mazar, Amir and Ariely (2008) p637-638
[58] Anand, Ashforth and Joshi (2004) p41-3
[59] Ariely (2012) p84
[60] Stucke, 2011 p277

against it. Nevertheless, senior staff could again use bonuses linked to company performance or other mechanisms to align employees' incentives with their own.

Diffusing responsibility

Poor standards in pre-crisis financial services

Prior to the financial crisis, firms in some fixed income, currency and commodities markets engaged in prohibited activities, including benchmark manipulation. One feature of such firms was that responsibility for overseeing compliance was delegated from front-line staff to firms' second and third lines of defence (support functions and internal audit respectively) and to regulators.[61] Sharing responsibility with other parts of the organisation is considered to have facilitated rule breaking by front-line staff.

Moral licensing and small steps to rule breaking

Moral licensing

When people make decisions over whether to comply with rules, the check that being a moral person has on self-interest can be overridden if people believe that they have absolved themselves of the need to hold themselves to particular standards. In this case, people can act as though they have a moral licence to pursue their self-interest, leading to more extensive rule breaking. Experimental evidence has found that, having established their moral credentials by purchasing 'green' rather than conventional products, people subsequently behaved less altruistically and were more likely to cheat and steal.[62]

One particularly relevent example of moral licensing in financial services markets occurs when sellers disclose their conflicts of interest. Some professionals face conflicts of interest when they give advice to people from which they could subsequently profit. Although there are usually rules against providing biased advice, these are often considered to be insufficient and dislcosure of conflicts of interest is often a proposed solution. However, once a conflict of interest is disclosed, giving biased advice may then seem to be a fair course of action, as the recipients of the advice can always take the conflict of advice into account. Experimental evidence shows that disclosure can increase bias in advice, while those receiving the advice do not sufficiently discount it for bias. Further evidence indeed shows that disclosing conflicts of interest reduces people's moral qualms over offering biased advice.[63]

[61] Fair and Effective Markets Review (FEMR), 2015 p59

[62] See Mazar and Zhong, 2010

[63] Cain, Loewenstein and Moore, 2010, p6-7

Moral licensing

Outsourcing ethics to regulators

One potential source of moral licensing occurs when regulators take on responsibility for activities involving ethical considerations that firms would otherwise untertake. By removing the need for the firm to take on responsibility for ethics, this can lead to firms perceiving that they do not need to hold themselves to such standards, as regulators are already doing that for them. For example, one feature of pre-crisis regulation was that, under the Approved Persons Regime, firms relied on the FSA to assess their own employees' fitness and propriety to perform their roles.[64] While some of the associated failures in compliance can be attributed to unclear lines of responsibility that resulted, it is likely that the FSA taking on responsibility for vetting staff ethics gave the impression that firms did not have to make such considerations themselves, leading to a reduction in the internal incentives that could have restrained rule breaking. Under the Senior Managers and Certification Regimes, firms took on more responsibility for certifying their own staff as being fit and proper.

First steps and small steps to rule breaking

Taking a first step towards wrongdoing can make subsequent rule breaking more likely. In this situation, having already violated their internal moral considerations, people then get the most out of their wrongdoing. This tendency has been referred to as the 'what-the-hell effect' compared to the tendency for people when dieting to give up entirely on their daily restrictions once they have committed infringement.[65]

For example, in some experiments people broke rules more frequently when they wore fake branded sunglasses than when they wore authentic ones.[66] After an initial act of wrongdoing, more severe infringements of rules can occur by increasing wrongdoing in small steps.[67] If people believe that the initial infringement appears to be morally justifiable, a small escalation in rule breaking may also appear to be modest and justifiable. After a series of similar escalations, although each incremental infringement may be small, the total effect may be significant.

Other considerations

Organisations can use internal mechanisms to induce their employees to break rules. If firms can create a sense of contractual obligation on the part of their employees, this can enable the employees to justify rule breaking to themselves more easily, on grounds that they would be doing wrong by reneging on the commitment that they had made to their employer.[68] People value consistency, and compliance can be achieved by inducing them to make a commitment.[69] This could occur even when individuals had no intention of entering into a commitment to break rules, if they did not have sufficient understanding of the contract into which they were entering. Similarly, organisations can present basic requirements for their employees that appear sensible in the abstract before they are used, but which can in fact be used to justify wrongdoing in practice.

As well as increasing the likelihood of inadvertent non-compliance, ambiguous or complex rules can make it easier to justify violations. If rules are unclear, they may permit self-serving interpretations. Likewise complexity in rules may permit selective interpretations that allow the reader to rationalise morally dubious activities as being consistent with their obligations under the rules.

[64] FEMR p59
[65] Ariely, 2012
[66] Gino, Norton and Ariely, 2010, p713-716
[67] Zimbardo, 2007 p274
[68] Zimbardo, 2007 p273-4
[69] Cialdini, 1984, p51

Tiredness can increase the likelihood of rule breaking. If decisions over compliance involve trade-offs between external incentives to break rules and internal considerations over morality, fatigue can make people less able to resist the effects of the external incentives. For example, some experimental evidence found that when people were first required to perform strenuous mental tasks they were subsequently more likely both to engage in cheating and to put themselves in situations in which they would be tempted to cheat.[70]

Giving potential rule breakers roles that appear to carry positive values can facilitate rule breaking. [71] For example, executives involved in price fixing are, at least until detection, perceived as respectable members of society.[72] In this case, it may be that the positive associations carried with the role of a respectable businessman and pillar of society make it easier to continue to see oneself as a moral person, even when undertaking rule breaking.

Conclusion

Morality can affect decisions to break rules, but the strength of moral constraints on rule breaking depends on the situation. If ethics are salient, and people are close to carrying out rule breaking and its effects, then moral considerations are brought to the fore and rule breaking is less likely. On the other hand if rule breaking occurs in small steps or people otherwise feel absolved of the need to take morality into account, then the risks of rule breaking are higher. In addition, rule breaking is more likely when drained decision makers face ambiguous or complex rules, and when the act of rule breaking is couched within roles that carry the illusion of positive values.

[70] Mead, Baumeister, Gino, Schweitzer and Ariely, 2009, p594-6

[71] Zimbardo, 2007, p273

[72] Stucke (2011) p274

5 Social context and group behaviour

Firms are organisations, so decisions about rule breaking are taken either by groups or by individuals in a group context. Group decisions are not, however, simple amalgamations of individual group members' preferences because the group context can alter the process by which decisions are made. Likewise being in a group situation can change individuals' beliefs and preferences, thereby changing their behaviour. This chapter examines how social context and group behaviour in firms affect compliance decisions.

Behaviour in groups

Social context can influence rational decision making in obvious ways. For example, seeing others in one's organisation cheating and getting away with it may have implications for the likelihood of detection, suggesting that the probability of being caught is lower than would otherwise be perceived. This increases the expected benefits of rule breaking, making it appear more attractive than it otherwise would. The psychological literature, however, suggests that social context affects compliance in more fundamental ways.

Group situations can change people's behaviour by altering their preferences, their beliefs and the way they make decisions. People change their own assessments to bring them into line with those around them. This 'informational conformity' occurs when people alter their beliefs in ambiguous or uncertain situations, determining what they believe is correct on the basis of what other people think is correct – a phenomenon known as 'social proof'.[73] As set out in chapter 2, being in a group can affect decision making in the case of groupthink, which occurs when cohesive groups join together prematurely on poor decisions. Informational conformity may in part drive such decision making, as individuals bring their beliefs in line with others' and reduce the challenge that poor decisions would otherwise face. Ultimately, informational conformity can change people's beliefs about social norms, applying particularly when people decide what constitutes 'correct' behaviour in a given situation.[74]

People also change their behaviour in order to gain acceptance from others in a group situation. 'Normative conformity' has the potential to change people's preferences, which take into account the reception of their actions within the group. Normative conformity also means that, even where people have different underlying beliefs and preferences to the group, they may alter their behaviour and act as though they did have the same beliefs and preferences. This can affect decision making, as in the example of groupthink, in which people do not voice their critical views for fear of poor reception from their group.

Regulatory rules can never be completely unambiguous, so some element of interpretation by the regulated firm will be required irrespective of whether regulation is prescriptive and rules-based, high level and principles-based, or a combination of the two. The way people interpret regulatory requirements depends on their 'frames' of what is involved in complying, meaning the expectations and prior experiences that determine how they interpret new information.[75] Social norms and firm culture play an important role in determining these expectations, so have important implications for the way that firms respond to regulation, including whether they inadvertently fail to comply.

The table below sets out the most important social and organisational drivers of rule breaking.

[73] Cialdini, 1984, p88

[74] Cialdini, 1984, p88

[75] Gilad, 2012, p3-4

Table 3: Social and organisational features contributing to rule breaking

Factor	Description	Example
Culture and social norms	Organisational culture and social norms have a significant effect on the extent of rule breaking.	Cheating becomes more widespread when people see others from their own 'group' cheating.
Ideologies	Presenting rule breaking as an ideology can establish norms in which cheating is accepted.	Prevailing ideologies within groups may serve to justify rule-breaking.
Benefiting others	It is easier to break rules for the benefit of others and still see oneself as a moral person.	Organisations motivate staff by making appeals to greater good of the business, which could encourage rule breaking to benefit colleagues.

Culture and social norms

There is strong evidence that organisational culture and social norms affect the likelihood of rule breaking. Studies of cheating in academic institutions have found that factors such as the extent of cheating and disapproval of cheating among peers have a strong influence on the likelihood that an individual will cheat.[76] Experimental evidence suggests that rule breaking is contagious and becomes more widespread when people see other people from their own organisations or social groups engaging in cheating.[77]

Indeed, this evidence also suggests that seeing cheating among others who are regarded as 'outsiders' makes people cheat even less than if they had not seen any rule breaking at all.[78] In another experiment, employees of a large, international bank behaved honestly until they were reminded of their professional identity as a bank employee. Such an effect was not found for other groups of employees.[79] Conversely, experimental evidence also suggests that people are more likely to engage in positive behaviour when they believe that individuals in similar circumstances behaved in the same way.[80]

[76] McCabe, Trevino and Butterfield, 2001, 222-223

[77] Theoretical models such as Bénabou and Tirole, 2011, and Bénabou, 2013, also show how social norms can become embedded in preferences. So acting in accordance with those preferences may be rational and not an example of behavioural bias.

[78] Gino, Ayal and Ariely, 2009 p396

[79] Cohn et al, 2014

[80] Goldstein, Cialdini and Griskevicius, 2008

Culture and social norms

Competition law violations

Certain firms and groups of firms display significantly worse behaviour than others. An international survey of 283 cartels over the period 1990-2005 found 174 instances of recidivism, with 86 companies violating price-fixing rules three or more times. The 11 companies with the worst record for recidivism were conglomerates from the EU with interests in petroleum or chemical manufacturing. Between them, they had over 160 convictions for price fixing and seven had been part of the same cartel.[81]

Poor standards in pre-crisis financial services

A feature of the firms that engaged in rule breaking such as benchmark manipulation in the period up to the financial crisis was often a culture in which the interests of individual traders diverged from the interests of orderly markets. In some trading teams, the notion that good conduct was a competitive disadvantage developed.[82]

How do negative cultures and norms become established in the first place? Rule breaking represents a failure of firms' internal controls, and a significant failure of these controls implies inadequate governance. While it is impossible for firms to eliminate fully the risk that their staff break rules, the behavioural evidence cited above suggests that a single failure in controls can lead to a much more widespread deterioration in firm culture.

Incentives can also be an important driver of culture. The way that members of a group respond to particular incentives shapes observed norms, which then affect behaviour more generally within the group as a whole. Poor culture within banks in the period leading up to the financial crisis is often attributed to the structure and levels of compensation, even by those within the industry.[83] Similarly, in retail financial services notions of 'supply-led markets' and products being 'sold, not bought', have been underpinned by the structure of commission based on sales targets.[84] Compensation can also drive cultural changes over time by influencing the type of character, from amongst appropriately qualified groups, who choose to join the firm.

Once established, norms are maintained through social proof. Approval may be a particularly strong motivator of individual behaviour in such situations.[85] Further, a lack of positive social norms can diminish the internal rewards for good behaviour and punishments for poor behaviour that we described in the previous chapter.[86]

Ideologies

Ideologies can be used to provide justifications for rule breaking and can take on a social dimension, becoming widespread within organisations.[87] Appeals to prevailing ideologies may then be used to show the desirability of breaching legal and regulatory rules. For example, within firms and industries that violate competition law, such breaches are sometimes justified with reference to higher principles, such as notions of 'ruinous competition', the 'evils of price cutting' and 'fair' prices or profits.[88]

[81] Connor and Helmers, 2006
[82] FEMR, 2015 p70
[83] Deloitte, 2013, p9
[84] Gilad, 2012, p10
[85] Reno, Cialdini and Kallgren, 1993
[86] Mazar and Ariely, 2006, p12-3
[87] Hirshleifer, 2008 p867
[88] Stucke, 2011, p279

Alternatively, appeals to higher loyalties, such as the ‘cause’ of the firm or duty to one’s leader, may be used to justify wrongdoing. Such appeals exploit cohesive groups’ tendency to put the group’s goals ahead of the good of other groups or society as a whole.[89] Alternatively, ideologies may aid the rationalisation of wrongdoing by denying the status of the victim of wrongdoing.[90] For example, in the context of mis-selling financial services products, this could involve the notion that the victims of mis-selling who bought the products knew what they were getting themselves into, or that they ‘deserved’ to be mis-sold to.

Another example of how ideologies can be used to affect behaviour is the changing of the semantics of breaking regulatory rules, for example, from harming consumers to helping shareholders. This may also help to justify rule breaking. The framing of wrongdoing can be relevant in such cases. For example, an employee seeking to override a firm’s internal controls might appeal to compliance officers’ desire not to be seen as ‘uncommercial’.

In a more widespread sense, prevailing ideas can affect how firms frame regulation. For example, in the period before the financial crisis, politicians put sustained emphasis on the need for the FSA to use a ‘light touch’ approach. For example, the Chancellor at the time, Gordon Brown, put a strong focus on the competitiveness of UK financial services and the risk that unnecessarily restrictive and intrusive regulation could harm this. The Prime Minister at the time, Tony Blair, also expressed concerns that heavy-handed FSA supervision impeded innovation.[91] It is likely that this emphasis from political leaders affected firms’ expectations, determining how they interpreted regulation.

Ideologies and the semantics of rule breaking

Collusion among NASDAQ market-makers

In one case of collusion in the United States, market-makers in NASDAQ stocks were increasing their spreads, and therefore their profits, by using a quoting convention of only quoting bid and ask prices for stocks with spreads of ¾ or more in quarters.[92] This practice was widespread and enforced among market-makers through the establishment of social norms, with violations of competition law effectively held up as ethical standards. The convention was effectively a self-imposed industry standard and part of the normal training on the job that traders received.

An important way of establishing and maintaining this norm was to establish an ideology which justified collusion in terms of ethics and professionalism. Failure to follow the quoting convention was regarded as being “unethical” or “unprofessional”.[93] In this way, ideologies of professionalism and ethical behaviour were used to justify violations of competition law and establish social norms in which such violations became an accepted industry standard. Challenging such norms requires an objective outsiders perspective to be heard.

Benefiting others

One feature of organisations is that they often attempt to motivate their staff by appeals to a sense of the greater good of the organisation or to a notion that the organisation is greater than the sum of its parts. While this can have many beneficial aspects for organisations, it may be that such environments lead to dishonesty, as people seek to find ways to distinguish themselves from their peers.[94] Rule breaking that benefits others is generally easier to justify than rule breaking that benefits oneself, meaning that people cheat more when they are part of a team than when they act as individuals.

[89] Anand, Ashforth and Joshi, 2004, p43
[90] Anand, Ashforth and Joshi, 2004, p42-43
[91] FSA, 2011 p260-2
[92] United States of America v Alex. Brown & Sons Inc.
[93] Stucke, 2011, p281
[94] Rick and Loewenstein, 2008

In experimental evidence, people broke rules more when both they and someone else benefited from cheating as part of a two-person team than when they alone benefited from it, even though they were scarcely acquainted. When the team members were able to build up a rapport, they engaged in even more rule breaking.[95] Other experiments have found lying to be more prevalent when the benefits of lying are shared with another team member.[96]

This finding is particularly relevant for rule breaking by regulated firms. If such rule breaking is profitable, the company as a whole will benefit from it, giving individuals the opportunity to engage in rule breaking to the benefit of their employers and colleagues. The potential for the company as a whole to benefit from rule breaking, combined with colleagues' rapport with each other, may therefore, provide strong impetus for rule breaking, even when rule breakers themselves would not benefit.

A particularly effective strategy for inducing rule breaking in staff may be to arrange for rule breaking to be the reciprocation of an initial beneficial act done by the beneficiary of rule breaking for the rule breaker. An initial beneficial act creates a strong sense of obligation, which can subsequently be exploited to induce rule breaking.[97]

Benefiting others

LIBOR manipulation

As set out above, LIBOR manipulation took place through banks' trading departments contacting LIBOR rate submitters, who altered the rates that they submitted. This means that the actual submission of incorrect rates data was done by some employees for the benefit of others within the organisation. In addition, this means that responsibility for the rule breaches was diffused, as the request to change submissions came from another department, which were the direct beneficiaries of the violations. Both of these factors are likely to have contributed to the scale of the scandal. In this case, it is also possible that traders' gifts to rate submitters, which ranged from meals in restaurants to champagne, created a sense of obligation that induced the submitters to agree to the traders' wishers.

Conclusion

The social context of compliance decisions within regulated firms adds further complications to decision making. The existence of groups can alter the way decisions are made, and being part of a group can change individuals' beliefs, preferences and behaviour. Culture and social norms can have a significant effect on the extent of rule breaking, as wrongdoing becomes more widespread when people see others from their group cheating. Ideologies can help to sustain rule breaking; helping to establish norms in which such wrongdoing is accepted. In a similar way, organisations can motivate staff to break rules by appealing to the greater good of the business, as it is easier to see oneself as a moral rule breaker if rule breaking benefits others. Further, organisations can structure themselves in ways that encourage employee rule breaking by creating a sense of contractual obligation around rule breaking.

[95] Ariely, 2012, p225-228

[96] Conrads et al, 2011

[97] Cialdini, 1984, p14-6

6 Changing the way firms make compliance decisions

In practice whether firms comply with regulation depends on a combination of incentives, governance, controls, culture and behavioural factors. While credible deterrence is an important component of an effective compliance strategy, effective approaches to compliance are also likely to include measures that change the context in which individuals make compliance decisions, in addition to other strategies to de-bias decision making. These include changes that regulators can make to their approach and other changes that firms can make to their business practices.

Changing the choice architecture of compliance

Our analysis of the behavioural drivers of rule breaking suggests a number of ways in which lessons from psychology can inform an analysis of firm compliance. Behavioural biases can affect individual decision making, in the assessment of the likelihood of detection, the nature of penalties and the effectiveness of internal controls and governance. Moral considerations can limit the extent of rule breaking, but the extent to which they do so depends on the context in which the individual makes compliance decisions. As people behave differently in group situations to when they act as individuals, features of organisations drive the behaviour of individuals within them.

These behavioural considerations explain why increasing penalties and improving regulatory surveillance may not in themselves be sufficient to deter poor behaviour. A better approach involves improving the 'choice architecture' that individuals face when they make compliance decisions. This refers to changing the situational factors that influence people's choices, thereby, increasing the likelihood that that their eventual decision is to comply. Where appropriate, such an approach would also involve other de-biasing techniques, but this is only appropriate for biases such as overconfidence that tend to increase the likelihood of rule breaking.

Table 4: Suggested ways to change the compliance choice architecture

Changes to choice architecture	Actions for firms	Actions for regulators	Drivers of poor behaviour this addresses
Changing perceptions of detection and punishment		Making punishments and detections salient and vivid; making regulatory communications of detections and punishments salient and vivid.	Salience and vividness bias; overconfidence.
De-biasing firms' decision making	Use of internal scrutiny and decision tools to minimise the impact of behavioural biases on their decision making.		Endowment effects, loss aversion, confirmation bias.
Enhancing the role of morality	Use reminders and moral codes to	Identify cases when the role of morality is	Low salience of morals and distance

Changes to choice architecture	Actions for firms	Actions for regulators	Drivers of poor behaviour this addresses
	engage moral reasoning; increase the salience of the consequences of non-compliance.	reduced; improve regulation.	from rule breaking.
Improving culture	Enhance the role of morality in individual decision making; ensure staff have the right incentives; combat ideologies that drive non-compliance.	Enhance the role of morality in individual decision making; combat ideologies that drive non-compliance; publicise examples of good behaviour.	Social and organisational drivers of poor behaviour

Changing perceptions of detection and punishment

Behavioural biases can break the link between compliance and the expected costs of wrongdoing, both with respect to the likelihood of detection and the level of punishment in the event of detection. Salience and vividness, alongside the availability heuristic, are likely to affect people's assessments of the likelihood of detection. This means that regulators can increase the expected costs of non-compliance by making their detection and punishments salient and vivid. For instance, it may be that detecting wrongdoing at a firm with a reputation for avoiding wrongdoing would be particularly vivid. Similarly, smaller punishments imposed on particular individuals are likely to be more salient, bringing the punishment to mind at the point of action, than large punishments imposed on a firm, which may in the end be borne by a large number of shareholders with diversified portfolios.

This also has implications for the way that regulators communicate their detection and punishment activities. Even though rational actors would be expected to alter their assessments of the likelihood of detection in response to new information, abstract statistics on the number of detections are unlikely to affect compliance, whereas, within firms and industries, stories about wrongdoers that skilfully avoided detection may have a significant effect on firms' perceived likelihood of detection. This is likely to be reinforced by overconfidence, which results in potential rule breakers feeling powerful and invulnerable, irrespective of what evidence indicates as to the likelihood and magnitude of punishment.

This suggests that regulators should focus their communication on salient and vivid instances of detection and punishment. This means that communications on detection should focus on attention-grabbing individual cases of detection, for instance, when regulators used unusual means to gather evidence and identify rule breakers. Similarly, it may be beneficial for communications to focus on the impact of punishment on individual rule breakers. For example, in the United States some anti-trust compliance programmes find it effective to include a former executive whose career was ruined by their involvement in price-fixing.[98] This approach has the advantage that it does not, in fact, depend on regulators being successful in detecting and punishing the majority of wrongdoing.

[98] Stucke, 2011

Changing perceptions of detection and punishment

Salient and vivid detection and punishment

Regulators can increase the expected costs of non-compliance by making their detection and punishment of wrongdoing salient and vivid.

Salient and vivid communications

Regulators can increase the perceived costs of wrongdoing by focusing their communication on salient and vivid instances of detection and punishment.

De-biasing firms' decision making

As we set out above, behavioural biases such as endowment effects and loss aversion can lead firms to become attached to existing poor practices, including the ineffective controls and governance processes that make rule breaking more likely. Similarly confirmation bias can lead to non-compliance, as staff make self-serving interpretations of regulation.

One of the lessons of the psychological literature on behavioural biases is that the 'bias blind spot' means that it is easier to spot such biases in others than it is to spot in oneself.[99] This means that, if appropriately designed, firms can use their organisational structure to mitigate behavioural biases by getting staff to identify biases in other staff. By engaging staff that do not have a personal stake in the design of controls and governance processes, firms are more likely to identify the flaws that can lead to subsequent rule breaches. Further, individuals who know that they will be held accountable for their actions are more likely to pay attention to their own biases and attempt to eliminate them.[100]

Such scrutiny can be enhanced by the use of decision making tools such as checklists, to de-bias their decision making.[101]Behavioural biases often occur in people's instinctive reactions and when they use mental shortcuts. One example is the use of rules of thumb or heuristics to assess facts.[102] The use of such mental shortcuts in a fast, associative and intuitive way is known as System I thinking, in contrast to System II thinking which is slow, analytic and deliberative. System II thinking can, therefore, be used to correct for biases that occur when people would otherwise use System I thinking.[103] Checklists can formalise the application of System II thinking, thereby, mitigating the impact of behavioural biases.

De-biasing firm decision making

Scrutiny and decision tools

Firms can use internal scrutiny and decision tools to de-bias their decision making to improve their governance and internal controls.

Enhancing the role of morality in decision making

Aside from the impact of behavioural biases, a further lesson from psychology is that rule breaking depends on the role of morality in decision making. The way people respond to the external incentives represented by the expected benefits and costs of rule breaking varies according to the extent to which the desire to see oneself as virtuous acts as a constraint on

[99] See Kugler and Pronin, 2007

[100] Beshears & Gino, 2015, p9

[101] See Kahneman, Lovallo, and Sibony, 2011

[102] Of course, rules of thumb are not necessarily a bad thing and may be a very good way to take complex decisions when information gathering is costly. And some rules of thumb may be informal applications of System II thinking.

[103] Sunstein, 2013, p231

wrong-doing. An implication of this is that firms that can that can bring moral considerations to the fore when their staff make compliance decisions can reduce instances of rule breaking.

To be effective, efforts to promote the salience of ethics need continually to engage employees' moral reasoning. Many firms require staff to engage in training on ethical issues, and the Chartered Institute for Securities and Investment requires candidates to pass integrity tests.[104] While these serve as useful starting points for enhancing the role of morality, they are unlikely to be effective if morality is not salient at the point at which employees actually make compliance decisions. Having staff sign up to moral codes or agreements, and subsequently using reminders to draw their attention to the requirements that they agreed to, could help to engage moral reasoning on a continuous basis. Having staff commit to abiding by moral standards is also likely to be more effective than ordering them to abide by them, as this exploits the influence that commitment can have on individual behaviour.

An important determinant of the role of morality in compliance decisions is the distance between the decision maker and the carrying out of and the negative consequences of rule breaking. One potential way to address this is to have employees meet consumers to make the consequences of employees' work more salient. In addition to enhancing the role of morality in decision making, having an 'identifiable victim' can have a significant impact on people's responses to harm to others.[105]

In other cases, when those affected by wrongdoing would not be a company's customers, it may be more effective to enhance employees' understanding of how their work has a real world impact. The goal of this, particularly within the financial services industry, would be to ensure that employees do not regard their work as simply 'numbers on a screen', but acknowledge the importance of a well-functioning finance sector for the wider economy.

Because of the role that morality plays in decision making over compliance, regulators and firms can determine when rule breaking is more likely to occur by identifying factors that tend to limit the role it plays in decision making. This includes when firms are structured such that responsibility for compliance decisions, and hence for non-compliance, is diffused, and when firms engage in activities that could be interpreted as absolving their staff from the need to engage in moral considerations.

The importance of morality in decision making also has implications for the form of regulation. Regulation that is itself excessively focused on processes that do not engage moral reasoning, such as tick-box compliance checks, risk reducing the salience of ethics in firm decision making. Likewise ambiguous or complex rules can enable rule breakers to maintain their perception of their own moral integrity even when they engage in wrongdoing. Reducing ambiguity can mitigate this, in addition to reducing the extent to which confirmation bias leads people to interpret rules in accordance with their own interests. Further, rules that remove the need for firms to engage with moral reasoning because such reasoning is seen to rest with the regulator risk 'licensing' firms to engage in wrongdoing that is not strictly prohibited by the precise letter of the rules.

[104]http://www.cisi.org/cisiweb2/cisi-website/integrity-ethics/promoting-professionalism

[105] Jenni and Loewenstein (1997)

Enhancing the role of morality in decision making

Moral codes and reminders

Firms can reduce rule breaking among their employees by having them commit to abiding by moral codes, and subsequently using reminders to ensure the salience of this commitment.

Increasing the salience of the consequences of non-compliance

Firms can reduce rule breaking by ensuring that their staff are aware of the consequences of their non-compliance for consumers.

Identify when the role of morality is reduced

Regulators and firms can identify when rule breaking is more likely to occur by determining in which firms morality plays a reduced role in decision making.

Improve regulation

Regulators can facilitate an enhanced role for morality by avoiding ambiguous rules or tick-box regulation, and ensuring rules engage employees' moral reasoning.

Improving culture

The culture within firms and industries can have a significant impact on the extent of rule breaking. At heart, poor culture within a firm amounts to a failure of leadership. Management within firms can influence their culture through their tone, through the training they give to staff and by setting out expectations of their staff. As well as improving individual decision making, it is likely that the steps set out above that firms could take to enhance the role of ethics would also promote a positive culture, because of the impact that social context has on the way people act. In addition, firms can ensure that their employees' incentives, particularly pay and bonuses, do not promote poor behaviour and thereby contribute to a poor culture.

Firms and regulators can also take steps to improving culture by directly combatting unhelpful prevailing ideologies. This could include detecting and addressing language and ideas within firms that trivialise unethical behaviour. Regulators could also strip rule breakers of their respectability or 'anti-hero' status through punishments and publicity. For example, HMRC explicitly names bank boards that have not signed up to its tax concordat. In the context of culture, being tough on small initial infractions to combat incremental wrong-doing could also be effective in achieving a positive culture.

Firms and regulators can also seek to identify circumstances in which staff use rationalisation strategies to enable them to maintain their conception of themselves as good people. These strategies include the denial of responsibility for wrongdoing, of injury as a result of wrongdoing and of the status of the victim of wrongdoing. They also include selective comparisons with even worse wrongdoers that flatter the rule breaker, appeals to higher loyalty and notions that the rule breaker has 'earned the right' to engage in wrongdoing.[106]

Regulators can also influence perceptions of the prevailing culture by identifying and publicising examples of good behaviour. This can help to mitigate poor compliance cultures by changing perceptions of the extent of rule breaking. For example, the FCA publicises good behaviour when it undertakes thematic reviews.

[106] Anand, Ashforth and Joshi, 2004

Improving culture

Leadership

Firms can promote a positive culture through their tone, training and the expectations that they set for their staff, and by enhancing the role of morality in individual employees' decision making.

Ensuring staff have the right incentives

Firms can avoid negative culture by ensuring staff remuneration does not promote poor behaviour.

Combatting unhelpful ideologies

Firms and regulators can promote a positive culture by combatting prevailing ideologies that trivialise poor behaviour.

Publicising examples of good behaviour

Regulators can influence perceptions of prevailing cultures by identifying and promoting examples of good behaviour.

Conclusion

In addition to regulators' efforts to detect and punish wrongdoing and the strength of firms' governance and internal controls, compliance with regulators' rules is determined by behavioural biases, morality and social factors. There are a number of options available to firms and regulators seeking to improve compliance. Changing perceptions of detection and punishment, de-biasing firms' decision making processes, enhancing the role of morality and improving firm culture all have a role to play in reducing the extent of rule breaking. We believe that collectively these ideas provide a useful basis for a strategic assessment of existing approaches to compliance.

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