Do Business Schools Incubate Criminals?

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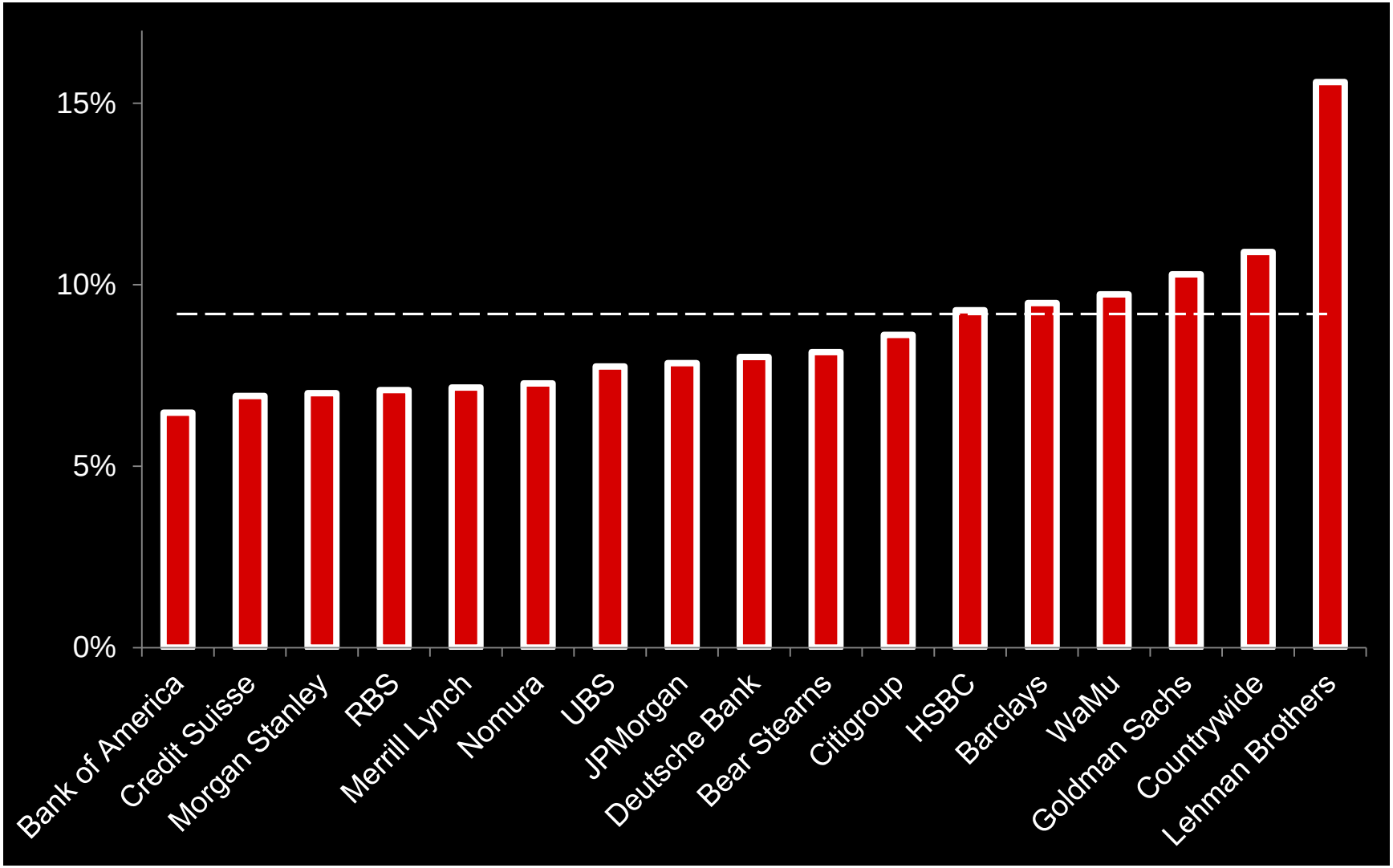
Pervasiveness of fraud

- Dyck et al. (2014) estimate that cost of (mostly financial) fraud among the U.S. companies with more than $750m in revenues is $380bn a year.
- In 2012-14 financial institutions paid $139bn in fine, $113bn of which for mortgage fraud.
- A whistleblower inside JPMorgan: 40 percent of the mortgages of some RMBS were based on overstated incomes (Querner, 2014).

Pervasiveness of fraud



Source: Piskorski et al. (2013)

Markets Manipulated

- Libor
- Foreign Exchange
- Gold
- Subprime Market

Banality of fraud

- Royal Bank of Scotland employees' emails

Senior Yen Trader: the whole HF (hedge fund) world will be kissing you instead of calling me if libor move lower

Yen Trader 1: ok, i will move the curve down 1bp maybe more if I can

Senior Yen Trader: maybe after tomorrow fixing hehehe

Yen Trader 1: fine will go with same as yesterday then

Senior Yen Trader: cool

Yen Trader 1: maybe a touch higher tomorrow

- There is no attempt to hide it, no sense of guilt. It is ordinary business.

We do not have the monopoly

- Fraud is not limited to Finance
  - GM hid defective devices
- or to the United States
  - VW devised a software to cheat on the diesel emission test
- Why fraud is so pervasive?

Reasons?

- Opportunities
  - Without emission standards, no violations
- Motives
  - As the economy is becoming increasingly winner-take-it-all, the benefit from cheating increases
  - As the perception of cheating increases, cheating increases
- Teaching?

Business Schools' Fault

1. Moral Agnosticism
2. Misplacement of Social Values
3. Wrong Corporate Social Responsibility Emphasis

1. Moral Agnosticism

- Most economists see their subject as divorced from morality, even legality.
- They liken themselves to physicists, who teach how atoms do behave, not how they should behave.
- But physicists do not teach to atoms and atoms do not have free will.
- If they did, physicists would and should be concerned about how the atoms being instructed could change their behavior and affect the universe.

Economists' View of Crime

- Becker (1968) compared the expected benefits of a crime with the expected cost of punishment (cost of punishment times the probability punishment).
- It is rational to commit a crime if

$$E(\text{benefits}) > E(\text{costs})$$

- Hence, it is irrational not to commit a crime when this condition is satisfied.
- What most people call "good, law obeying behavior", we call "irrational"

Cost of Moral Agnosticism

- When economists pretend to be agnostic, they subtly encourage amoral behavior without taking any responsibility.
- Not choosing is choosing not to choose
- Economists are not moral philosophers, and we have no particular competence to determine what is ethical and what is not.
- We are, though, able to identify behavior that makes people better off.

Moral Disengagement

- If everybody does it, we do not feel guilty about it.
- Teaching moral hazard and adverse selection make our students believe everybody does it
- Hence, they feel entitled to do it as well.

2. Misplacement of Social Values

- People are not only motivated by money, but also by prestige.
- Social prestige is used to compensate activities with low monetary returns
  - military heroes
  - dedicated missionaries
- In BS we tend to reward with prestige monetary success
  - Prizes
  - Choice of trustees

- We celebrate often regardless of the way it is achieved
  - Lax screening of donors
- No soul searching over criminal trained in business schools, even when it is not an isolated case
  - Anil Kumar -- Wharton School -- pleaded guilty to providing insider information to hedge-fund manager and fellow Wharton alumnus Raj Rajaratnam
- Evidence that classmates leak information

3. Wrong CSR Emphasis

- Milton Friedman famously said the only social responsibility of business is to increase its profits.
- But he added “so long as it stays <u>within the rules of the game, which is to say, engages in open and free competition without deception or fraud</u>.”

Implications

1. Violating the rule is not socially responsible even for Friedman
2. Committing fraud is not socially responsible
3. Preying on customers' addictions or cognitive limitations constitutes deception, if not outright fraud.
4. Lobbying to secure a monopoly right does not represent "open and free competition."

Wrong Emphasis

- CSR attention on child labor, environmental concerns, etc. seem a purposeful distraction from the real issues
  - Legality
  - No fraud
  - No rigging of the competitive rules

Conclusions

- No amount of education can prevent some people from engaging in bad behavior.
- It can contribute to a social consensus that would discourage diffuse fraud
- The daily scandals are not merely the doing of isolated crooks.
- They are the result of an amoral culture that we -- business-school professors -- helped foster.