Business Ethics Tutorial

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Business Case Studies
Part I
Business case studies

• Countrywide Financial
• Misleading numbers
• Marketing Prozac
Reminder

- I am not presenting my opinions
  - I don’t have opinions.
  - I am presenting some arguments and their conclusions.
- This is not the final analysis.
  - It is only an illustration of what ethical reasoning looks like.
Countrywide Financial

• The subprime mortgage debacle.
  – In 2007, Countrywide Financial was largest mortgage lender in the U.S.
  – 9% of loans were subprime (20% nationally).
Countrywide Financial

- The subprime mortgage debacle.
  - Global credit freeze in late 2008
    - Subprime loans were repackaged as mortgage-backed securities.
    - They received high ratings but were quickly regarded as “poison.”
    - $62 trillion in outstanding credit default swaps.
Countrywide Financial

• The subprime mortgage debacle
  – Countrywide’s demise
    – CEO Angelo Mozilo complained of “overreaction” to subprime loan situation.
    – Yet the company sold out to Bank of America in July 2008 for 1/6 of its value a year earlier.
Countrywide Financial

- Subprime loans
  - Can have a legitimate purpose.
  - But they commonly lured borrowers into a risky position.
    - “2/28” and other adjustable rate mortgages were common.
    - It was assumed home values would continue to rise.
    - Due diligence was neglected because mortgages were sold off and “securitized.”
    - This contributed to a bubble in house prices, which burst in late 2006.
  - Interest rates rose and many houses were “under water.”
Countrywide Financial

• **Issue 1:** When is making a subprime loan ethical?

• **Utilitarian test**
  – If expected utility for borrower is negative, it is probably negative for the lender, too.
    – Don’t make the loan.
  – If expected utility for borrower is positive, the issue is harder.
    – Suppose it was reasonable to believe that house values would not drop much.
Countrywide Financial

• Generalization test
  – Even if expected value for borrower is positive, there is much risk.
    – Let’s suppose the lender provides full disclosure about the terms of the loan.
    – But the lender knows that the borrower is underestimating the risk.
    – Perhaps the borrower is unaware that lenders now have no incentive to minimize risk.
Countrywide Financial

• Generalization test
  – When can we say *caveat emptor*?
    – Business as we know it requires some degree of trust in the seller.
    – The buyer can’t be an expert on every product.
  – The seller’s actions are ungeneralizable if they presuppose a level of trust that would not exist if all sellers behaved similarly.
    – Countrywide Financial presupposed that borrowers would not question the due diligence of lenders.
    – This doesn’t (didn’t) generalize.
Countrywide Financial

- Generalization test
  - Conclusion…
    - At a minimum, the lender should make sure that the borrower is fully apprised of the risk (in addition to the terms of the loan).
    - In particular, the borrower should understand that lenders no longer have an incentive for due diligence.
    - …even if the loan has net positive expected utility.
  - Failure to perform due diligence…
    - Deceptive (and ungeneralizable) if the bank buying the loan assumes otherwise.
Countrywide Financial

• Issue 2: Foreclosure vs. renegotiation of loan
• Assumption
  – There was no fraud or misrepresentation in granting the loan
    – Only a failure to correct borrower’s underestimate of the risk.
  – This was unethical, but now we are examining the ethics of foreclosure.
Countrywide Financial

- Utilitarian test
  - Renegotiation probably maximizes utility.
    - Perhaps for both lender and borrower.
  - So the lender should renegotiate unless this fails another ethical test.
Countrywide Financial

• Moral hazard?
  – Borrowers would take out loans they can’t afford if they don’t have to repay them.
  – Sounds like a generalization test.

• Generalization test for renegotiation
  – Suppose mortgage holder benefits from renegotiation.
  – Renegotiating contracts when both parties benefit is generalizable.
  – In this case, mortgage holder should renegotiate to satisfy utilitarian principle.
Countrywide Financial

− Now suppose mortgage holder does not benefit from renegotiation.
  − Even though renegotiation maximizes total net utility.

− Reason for renegotiation:
  − Avoid the disutility of foreclosure.

− Moral hazard isn’t precisely the problem.
  − If lenders always relaxed terms, the system would account for this by tightening the initial terms.

− But renegotiation is ungeneralizable.
  − Generalization is inconsistent with mortgage holder’s purpose of avoiding foreclosure.
Countrywide Financial

- Conclusions
  - A subprime loan can be ethical...
    - If there is no fraud or misrepresentation.
    - And if the net expected utility for the borrower is positive.
    - And if the borrower is fully apprised of the risk, including the fact that the lender may lack an incentive for due diligence.
Countrywide Financial

• Conclusions
  – Foreclosing on a subprime load is ethical if, and only if…
    – There was no fraud or misrepresentation in making the loan.
    – And renegotiating would **not** benefit the mortgage holder.
Countrywide Financial

- Public policy
  - This is another issue.
  - Perhaps the government should incentivize renegotiation (it has).
  - This, or persuasion alone, could change the ethical status of renegotiation.
Misleading numbers

• My boss asked me to omit numbers for a poorly-performing mutual fund…
  – …from a report to clients.
    – This was legal but misleading
    – Conversation was one-on-one, no paper/email trail.
  – My boss was concerned about our fiduciary duty to stockholders.
Misleading numbers

- Issue 1: Is it unethical to omit the numbers?
  - All the information in the report is correct.
- Issue 2: If it’s unethical, do I have an obligation to refuse?
Misleading numbers

• Issue 1: Is it deceptive to omit the numbers?
  – Deception is ungeneralizable.
    – Deception = causing something to believe something you know is false.
  – In particular, omitting bad numbers from a report is ungeneralizable.
    – If generalized, customers would toss such reports in the trash.
Misleading numbers

• Issue 2: How high a price must I pay to be ethical?
  – There’s clearly a limit.
  – But what is it?
Misleading numbers

• Utilitarian test
  – First, try to compromise.
  – Utilitarian consequences unclear.
    – My job is at risk. So is my reputation for honesty.
    – These affect others as well as myself.

• If I don’t do it someone else will.
  – This at best shows there is no utilitarian objection.
Misleading numbers

- Generalization test
  - Obeying the boss to protect one’s career may be generalizable.
  - But obeying the boss *by misleading clients* to protect one’s career is not generalizable.
- If there is a serious threat for failing to obey…
  - Ungeneralizability argument breaks down.
    - If all employees deceived customers only under a serious threat (they would do so now), such threats would not become commonplace (they aren’t now).
Misleading numbers

- **Virtue ethics**
  - Deception is dishonorable.
    - Honor should not be sacrificed except for the sake of preserving another virtue.
    - If I have heavy obligations due to illness in the family, I must balance honor against loyalty.
    - This is generalizable because it is in effect a serious threat.
  - Also my *profession* is giving financial advice.
    - The boss is asking me *not* to be a financial advisor.
    - This is intolerable if it continues.
Misleading numbers

• Scorecard
  – Generalization test: fail
    – Except with unusually heavy family obligations.
  – Utilitarian test: pass
    – Because inconclusive
  – Virtue ethics: fail
    – Except with unusually heavy family obligations.
  – Problem: Western ethics is oriented toward individuals, not organizations.
Marketing Prozac

- Prozac is an anti-depressant
  - Marketed by Eli Lilly.
  - Selective serotonin reuptake inhibitor.
    - Low levels of the neurotransmitter serotonin are associated with depression and other disorders.
  - Created enormous buzz when released.
Marketing Prozac

• The issues
  – Is “pull” marketing ethical?
    – $2.5 billion/year spent by pharmaceutical companies in USA.
  – How about “psychological” persuasion?
Marketing Prozac

• Problems with Prozac
  – Takes several weeks to start working.
  – Can have side effects.
  – No more effective than its predecessors.
  – Creates some dependency.
  – Not intended to make one extroverted or socially acceptable.
Marketing Prozac

• **Pull marketing**
  – **Aim:** Persuade customers to ask their physicians for a prescription.

• **Utilitarian test**
  – This is the key test, probably passed.
  – Aggressive marketing can lead to abuse of drug.
  – However, depression is under treated.
    – A debilitating disease.
    – May not be self-diagnosed.
    – Patients may not be aware of treatment options.
Marketing Prozac

- Psychological persuasion
  - Is “psychological manipulation” OK in advertising?
  - It’s a question of autonomy.
    - Suppose they put something in the water.
    - Manipulation is often associated with deception, which is unethical.
    - But deception is not the only problem.
    - Manipulation subverts autonomy.
    - Seduction need not be manipulation.
Marketing Prozac

- Psychological persuasion
  - Appeal to emotions may be perfectly OK.
    - May supply information relevant to a product.
    - For example, appeals for hunger relief.
    - Presents the options, allows rational choice.
  - How about Prozac ads?
    - OK if they show what Prozac can do for you – and to you.
    - Not OK if they appeal to insecurities, etc., that interfere with rational choice.
Marketing Prozac

- Temptation
  - Temptation is not manipulation.
    - May make rational choice **harder**, but doesn’t interfere with it.
  - So it’s a utilitarian question.
    - Unless deception is involved.
    - Occasional temptation can be fine.
    - We have already granted that Prozac ads pass the utilitarian test.
Marketing Prozac

• Conclusions
  – Pull marketing of Prozac seems to increase utility.
    – It is ethical if it passes other tests.
  – Appeal to emotions in an ad can be ethical, but psychological manipulation is not…
    – …if it compromises autonomy.
  – Prozac ads need a second look.
Next

• More business case studies