

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).

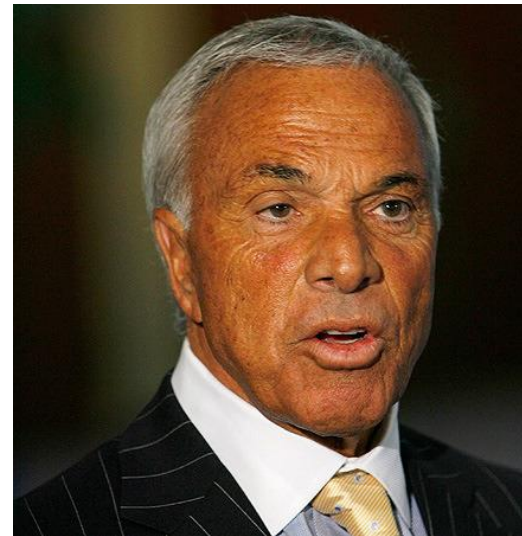


Countrywide Financial

- 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 loan 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

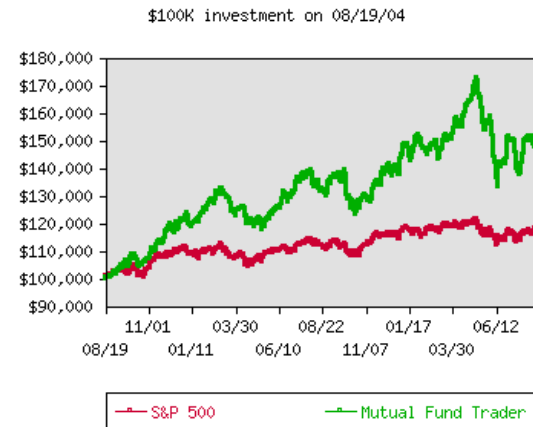
- Public policy
 - This is another issue.
 - Perhaps the government should incentivize renegotiation (it has).
 - This, or persuasion alone, could change the ethical status of renegotiation.

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