Introducing Ethics into the Finance Curriculum: A Simple Three-Level Guide

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Ethics has arrived in the business school curriculum. But what about the curriculum of finance? Can ethics be integrated in any meaningful way into the theory and pedagogy of finance? Given the ever-broader array of topics in finance, should ethics be included at the inevitable expense of something else? Are finance instructors qualified to teach ethics any more than ethicists are qualified to teach finance? In short, are finance educators doing students a service or disservice by devoting class time to ethics? These are the questions addressed here. A menu of three different levels of integration is supplied; each level requiring a different commitment of curricula resources.

INTRODUCTION

Ethics is now a permanent fixture within business-school curricula. Accreditation bodies, such as the Association to Advance Collegiate Schools of Business (AACSB), are following the lead of professional organizations, such as the Chartered Financial Analyst (CFA) Institute, in promoting business ethics education. But the question still remains of how best to integrate ethics into the business school curriculum.

Business schools vary considerably in terms of size, academic focus, and resource availability, so a one-size-fits-all answer to this question would be overly simplistic. What is clear, however, is that some level of ethics integration is essential given the current business and administrative milieu. This article focuses specifically on the integration of ethics into the subject area of finance. It begins from the premise that the decision has been made to integrate ethics into the finance curriculum. Three levels of integration are discussed.

Integration Level One

This level requires the minimum commitment necessary to achieve some meaningful integration. Students are merely made aware of the fact that finance involves assumptions about human behavior and that this behavior is both complex and suggestible.
Integration Level Two

This level requires an intermediate resource commitment. Students are assigned cases and readings on ethical issues in finance. Class time is devoted to discussion of these cases and readings in terms of applying ethics theory to the practice of finance.

Integration Level Three

This level requires a significant resource commitment, including modification to the curriculum and probably the employment of additional instructors. The finance department offers a class specifically on 'Financial Ethics'.

Which one of these three levels is optimal for any given finance department will depend on factors such as the size of the department, the flexibility of the existing curriculum, the physical resources available, and -- most critically -- the intellectual resources available in the form of faculty willing and able to devote time to the coverage of ethics. The three levels of integration, therefore, represent three levels of departmental commitment to the integration of ethics into the subject area of finance. The remainder of this article fleshes out each of these integration levels.

INTEGRATION LEVEL ONE

Concisely defined, ethics is the study of the best justification for action. Thus ethics is the normative (i.e., prescriptive) study of rationality. At the practical level, a knowledge of ethics theory gives individuals the intellectual skills necessary to best answer the question, 'What should I do?' This question is of course faced continually by any rational individual in many circumstances, including business circumstances, where more than one course of action is available (what game theorists call a "decision node"). Any normal life, particularly any normal life in business, is a mass of sequential decision nodes.

Answering this question, 'What should I do?' is not simple; two-thousand years of moral philosophy attests to this. And clearly a typical finance class is not a suitable venue for an elucidation of this philosophy. But merely making students aware of the fact that this is a question to which they should devote serious thought -- i.e., they are not 'hard-wired' to act in any particular way -- is a significant contribution to the introduction of ethics into finance. This represents Level One Integration. The critical first question that any finance educator must address, therefore, is how far to go: How much time is going to be devoted to elucidating this ethical aspect of finance?

To some extent this will depend on the type of material being covered in the finance class. If the material is largely technical in nature with little to no bearing on human behavior -- i.e., on the question 'What should I do?' -- then a discussion of ethics is inappropriate. But if the material does address behavior then a discussion of the justification for the behavioral choices -- i.e., a discussion of ethics -- is very appropriate.

Traditionally, finance has tended to be seen as personal wealth maximization, with performance based incentive structures aligned with that of principals.

More recently, however, behavior as opportunistic wealth maximization even in financial contexts, is actual agency theory would imply. Spontaneous, unpredictable ways but also -- behavior is malleable and open to be, or in ways that they observe their peers behavior, agency theory, opportunistic ways.

Lesson Plan

What follows is a suggested class. This plan is condensed from Rationality of Virtue(1997). It a and is intended to provide finance conduct a meaningful discussion.

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Explicit Contracts

Broadly defined, explicit contracts themselves to legal enforceability bondholder covenants, union wages, and rights. There are three basic pro.

1) Feasibility: The intangible or explicit contract unfeasible.

2) Cost: Even if theoretical costs expensive given legal fees and
Traditionally, finance has taken a pretty simplistic view of human behavior. Agents were personal wealth maximizing opportunists. Hence the heavy promotion of performance based incentive schemes as a means of aligning this self interest of agents with that of principals.

More recently, however, behavioral finance has questioned this notion of rationality as opportunistic wealth maximization. Researchers have found that human behavior, even in financial contexts, is actually far more complex and suggestible than traditional agency theory would imply. Specifically, not only do people behave in complex and unpredictable ways but also -- and this is crucial to our present discussion -- people's behavior is malleable and open to suggestion: people behave in ways that they are told to behave, or in ways that they think they are supposed to behave, or in ways in which they observe their peers behaving. In short, contrary to the assumptions of traditional agency theory, opportunistic wealth maximization is not a law of nature.

Lesson Plan

What follows is a suggested framework for introducing ethical issues into a finance class. This plan is condensed from Chapters One, Two, and Three of Finance Ethics: The Rationality of Virtue (1997). It approaches ethics from the perspective of agency theory, and is intended to provide finance instructors with the minimum tools necessary to conduct a meaningful discussion of ethics in finance.

The business environment -- as viewed through the lens of conventional finance -- comprises a complex web of interrelated interest groups, each distinguishable by their unique set of objectives and constraints. Indeed, since the pioneering work of Robert Coase on The Nature of The Firm (1937), corporations have been viewed as mechanisms for minimizing the costs and maximizing the efficiency of these contractual relations or agency problems. Although contractual agreements between stakeholders take on many forms, a general distinction can be made between explicit contracts and implicit contracts.

Explicit Contracts

Broadly defined, explicit contracts are those that appear in writing and lend themselves to legal enforcement (albeit at a cost). Examples of such contracts are bondholder covenants, union wage contracts, product warranties, and shareholder-voting rights. There are three basic problems with explicit contracts:

1) Feasibility: The intangible nature of a business arrangement may simply make an explicit contract unfeasible.

2) Cost: Even if theoretically feasible, an explicit contract may be prohibitively expensive given legal fees and other documentation costs.
3) Enforceability: Any explicit contract is binding only if it is recognized as being enforceable. If those bound by the contract do not feel that the contract is enforceable, then they will feel free to breach it with impunity. Therefore, no matter how well it is drawn up, the contract will have little practical value.

Implicit Contracts

Because of the above problems, much financial interaction relies on implicit contracts. Implicit contracts do not readily lend themselves to legal enforcement; they are "too nebulous and state-contingent to reduce to writing at reasonable cost" (Cornell and Shapiro, 1987, p. 6). Examples of implicit contracts are many and varied. The most common include a producer's commitment to product quality, a stockbroker's commitment to execute a client's security transaction at the best available price, or management's commitment to act in the interests of shareholders. The analysis of implicit contracts in finance generally comes under the nomenclature of agency theory.

Agency Theory

Agency theory analyzes situations in which "one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision and moral hazard. The differences of the nature and degree of uncer...

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involves delegating some decision making authority to the agent' (Jensen and Meckling, 1976, p. 308). These situations take on many forms in finance. Some of the most common would include the following:

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<td>shareholder</td>
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These agency relations can be loosely categorized into two types: adverse selection and moral hazard. The difference between these two categories is essentially a function of the nature and degree of uncertainty inherent in the contractual situation.

Adverse Selection

In adverse selection, the uncertainty stems from an asymmetry of information that precludes the principal from costlessly identifying the type of agent. Asymmetry of
information is common in agency relations. The classic such relation in finance is that of managers and shareholders (see Figure 2): shareholders may be unable to costlessly determine the true earnings expectations of managers.

For example, consider two firms: “Good” and “Bad.” The Good firm has relatively superior future earnings prospects, whereas the bad firm has relatively inferior future earnings prospects. The firms cannot choose whether they are good or bad (formally, the agent’s type is exogenously determined). Furthermore, the different earnings prospects of the two firms are not readily apparent from their financial statements or other generally available information. Thus the contractual environment is one characterized by informational asymmetry: the agents (i.e., the insiders or managers of the firm) know more about their respective firm’s prospects than do the principals (i.e., the outside investors).

The ability of the principals to make optimal (i.e., wealth maximizing) investment decisions is a function of their ability to distinguish between the Good firm and the Bad firm. Thus the agency problem stems directly from the informational asymmetry. Since a firm’s type is not directly observable, principals attempt to make inferences from signals emitted—either advertently or inadvertently—by the firms. For example, the Good firm might consistently pay a large cash dividend that the Bad firm cannot afford to imitate given its inferior earnings.

Equilibria

If the Good agent is able to devise and emit an effective signal, then it engenders what agency theorists term a separating equilibrium in which the two agents become distinguishable to principals and thus the informational asymmetry is overcome. If such a signal does not exist, then the informational asymmetry endures and a pooling equilibrium ensues:

- Separating Equilibrium: The principal is able to discern the different types of agent, whether the agent is the manager of the Good or Bad firm.

- Pooling Equilibrium: The undesirable outcome from the principal’s perspective in which the principal is unable to distinguish the agent’s type.

Even if a separating equilibrium is achieved, note that there are generally costs involved. A successful signal, whether it be a large dividend payout or some other, can often be costly for the agent to emit. If the signal is not costly, then it is something the “Bad” agent might easily be able to mimic. In other words, if there had been no initial informational asymmetry or if the Bad agent chose to honestly reveal its type, then the Bad agent would often be no worse off and the Good agent would be better off through not having to fund the signal.

Formally, the separating equilibrium is said to be second best because there is a deadweight or ‘dissipative’ cost that is not recouped by the other agent overcame, are not zero-sum games of wealth from principal to agent, in aggregate.

Moral Hazard

If each agent above could attain information asymmetry without the need for motivations to mimic superior temptations on the part of the agent, the interests of the principal is to select contains at its heart represents the fundamental behavioral dilemma: fundamental behavioral dilemma: basic conflict of asymmetry is minimal, there moral hazard: basic conflict of

The classic agency problem, firm moves from private to pu
such relation in finance is that may be unable to costlessly ers may be unable to costlessly The Good firm has relatively has relatively inferior future y are good or bad (formally, the the different earnings prospects financial statements or other environment is one characterized s or managers of the firm) know the principals (i.e., the outside wealth maximizing) investment veen the Good firm and the Bad informational asymmetry. Since : to make inferences from signals ms. For example, the Good firm ad firm cannot afford to imitate effective signal, then it engenders which the two agents become asymmetry is overcome. If such asymmetry endures and a pooling discern the different types of or Bad firm.

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that there are generally costs lend payout or some other, can costly, then it is something the rds, if there had been no initial onestly reveal its type, then the nt would be better off through second best because there is a deadweight or 'dissipative' cost levied on the economy in aggregate (a cost to one agent not recouped by the other agent or the principal). Thus agency problems, even if they are overcome, are not zero-sum games. We are not dealing merely with a redistribution of wealth from principal to agent, but rather with an absolute wealth loss to the economy in aggregate.

Moral Hazard

If each agent above could be relied upon to honestly reveal its type, then the informational asymmetry would disappear and a separating equilibrium would be attained without the need for costly signals. But inferior agents may well have motivations to mimic superior agents and thus perpetuate the agency problem. This temptation on the part of the agent to act in his or her own interest rather than in the interests of the principal is termed moral hazard. Thus every situation of adverse selection contains at its heart the problem of moral hazard. As such, moral hazard represents the fundamental behavioral dilemma of agency theory, and indeed the fundamental behavioral dilemma of financial economics. Thus even if informational asymmetry is minimal, there may still be a significant agency problem in the form of moral hazard: basic conflict of interest.

The classic agency problem of this type is managerial perquisite consumption. As a firm moves from private to public ownership, there is a separation of ownership and
control. The owners bear the cost of managers’ perquisite consumption (e.g., business lunches, corporate jets, etc.) but the managers make the decisions on how many “perks” to consume. Barring effective accountability—in other words barring a resolution to the agency problem—a “rational” wealth-maximizing management, who no longer bears the full cost of its perks, may be predisposed to consume perks to an excessive degree, to a degree that compromises the value of the firm as a whole. Potential shareholders and bondholders, cognizant of management’s “rational” predisposition, will lower the price at which they are willing to buy the firm’s equity or debt.

This agency problem of moral hazard is illustrated by the game tree in Figure 3, which depicts a simple conflict of interest between two players: A and B. Player A might represent a group of shareholders considering an investment in a company whose management is represented by player B. David Kreps summarizes the game’s play as follows:

First A must choose whether or not to trust his opponent. If he (A) elects not to trust B, then both A and B get nothing. If he elects trust, B is made aware of this fact and is given the option either to honor that trust or to abuse it. If A trusts B and she (B) chooses to honor that trust, both get $10. But if A trusts B and she chooses to abuse it, B gets $15 and A loses $5. (1984, p. 12)

Assume that each player’s payoff from the game is common knowledge. In other words there is no informational asymmetry and to the extent that there is an agency problem it would be characterized as one of simple moral hazard. As Kreps explains, the game begins with player A deciding whether or not to trust player B. If he (A) does decide to trust B, then she (B) must decide whether to honor or abuse that trust.

Those of you familiar with Game Theory will recognize Figure 5 as a one-sided version of the infamous Prisoners’ Dilemma game. If we assume that both players are rational in the financial-economic sense, and thus are primarily motivated to maximize their payoff, then presumably, if called upon to move, B will abuse the trust vested in her by A. Realizing this, A will never offer trust, and a contract between these two players will not be entered into. The most reasonable outcome for this game, therefore, is for each player to receive a payoff of $0.

However, such an outcome is clearly not the most desirable, either from the point of view of the two players as individuals or from the point of view of the economy as a whole, in that the maximum total payoff of $20 is not attained (this would be the first-best outcome). The unwillingness of player A to trust player B has cost both players $10. But then why should B honor trust if her immediate payoff is maximized by abusing it? And whatever B might actually plan on doing, why should A assume that B is going to honor trust when he can see that abusing it yields her the higher payoff?

How can this desirable outcome, based on mutual trust, be reached? Given these economically ‘rational’ agents, there is only one way it can be reached: through a predisposition on the part of player B to build and maintain a reputation.

Conditions Necessary for Reputation

Condition 1: Compliance with contracts

Condition 1 has been made.

Condition 2: Agents are sequentially rational

A sequentially rational agent chooses a function and a strategy that can contribute to the maximization of his payoff, a contractual environment characterized by flexibility and dependent upon previous players’ experiences, and rationality is clearly essential because reputation is based on the behavior on the basis of this model.

Condition 3: Agents operate in a supergame

A supergame is a series of contracts, for example, repetitions of the game, by the participation of a common agent who endures throughout. The agent building the reputation supergame is either of infinite duration, or not the supergame is infinite in duration. If a supergame is of infinite duration, then the game collapses into a one-time game. Knowing this, the principal will offer trust; consequently, the agent will honor trust.

Knowing this, the principal...
The Reputation Solution

Reputation-building behavior involves the sacrifice of short-run income in the expectation of greater long-run income. In Figure 3, for example, player B will sacrifice $5 per play of the game in order to maintain her reputation for honoring trust. She would rationally do this in order to induce the principal to offer trust in future plays of the game. Reputation, therefore, would appear to remedy the fundamental agency problem. But just how reliable is this reputation solution?

Conditions Necessary for Reputation to Work

Condition 1: Compliance with contracts is value-enhancing for agents.

Condition 1 has been made implicitly in the discussion of the previous sections. Clearly, for reputation to be valued, the enforcement of contracts must in some way contribute to the maximization of agents' objective function.

Condition 2: Agents are sequentially rational, i.e., memory and learning exist.

A sequentially rational agent has two notable attributes: a multi-period objective function and a strategy that can be modified in light of new information. Therefore, in a contractual environment characterized by sequential reality, an agent's strategy is flexible and dependent upon previous experiences. For reputation to work, this type of rationality is clearly essential because if agents had no memory, or if they did not modify behavior on the basis of this memory, reputation would be meaningless.

Condition 3: Agents operate in a supergame environment.

A supergame is a series of contractual situations, i.e., sub-games like Figure 3, linked by the participation of a common agent. In the case of reputation building, the common agent who endures throughout the supergame must be the reputation builder. For example, repetitions of the game depicted in Figure 3, in which player B endures, would be a suitable supergame. There may be many player A's as long as each can observe the previous players' experiences, and thus learn from them.

The agent building the reputation (player B in Figure 3) must also believe that the supergame is either of infinite duration, or that there is some uncertainty over whether or not the supergame is infinite, or that there is some uncertainty over the agent's rationality. If a supergame is of known finite duration, then a simple argument reveals that the game collapses into a single-play environment: on the last iteration of the supergame, both players know that the agent will abuse trust, thus the principal will not offer trust; consequently, the agent will rationally renege on the penultimate iteration.

Knowing this, the principal will not offer the contract on the penultimate repetition,
etc. The game unravels with no reputation effect.

Condition 4: The behavioral trait upon which contractual enforcement rests (and for which the reputation is built) is observable ex-post by the principal, but not costlessly verifiable.

Condition 4's rationale becomes apparent if extreme scenarios are considered. A firm endeavoring to build a reputation for timely debt repayment behavior would be unwise to issue twenty-year, zero-coupon-rate bonds. If it were to do so, the firm would clearly not start building its reputation for twenty years, since its ability to repay the debt would not be tested until then. Contrarily, if the firm were to issue coupon-paying debt (or short-term, zero-coupon debt) its reputation could be built considerably faster. Similar logic has been applied in the context of reputation's ability to distinguish superior mutual-fund performance: 'since the amount of time it takes to discern quality of portfolio performance is lengthy in financial markets, reputation is unlikely to have much substantial basis. Inferior performers should survive for a long time, as is consistent with empirical evidence" (Dybvig and Spatt, 1985, p. 4).

At the other extreme, if contracts are costlessly verifiable, then explicit enforcement would be costless and reputation's role as an enforcer of implicit contracts would be trivial. Thus reputation clearly requires the existence of at least some simple moral-hazard-type market imperfection as is the case, for example, in Figure 3.

Reputation and Adverse Selection

Conditions 3 and 4 above imply that, when valuing an implicit claim, the principal should consider the strategy of the claim seller, i.e., the agent. If it appears probable that the agent believes the supergame is near termination (e.g., the agent is soon to retire or shift geographical location), then the principal should exercise caution when purchasing implicit claims valued on the basis of the agent's reputation.

Similarly, if the principal believes that the fundamental tenets of a supergame environment do not apply unambiguously to the claim in question, then caution must again be exercised in valuing that claim. For example, a reputable small-town auto mechanic may have little incentive to maintain her reputation while working on an out-of-state car that she believes is just passing through town (at least this is true within the finance paradigm, we ignore for now the idea that this mechanic may feel some moral compunction to service the car well). In this situation, Condition 3 is clearly breached: the principal (transient car owner) will be unable to pass on his opinion of the repair work to future principals (i.e., future auto-repair customers).

Condition 4 requires that the behavioral trait for which the agent builds a reputation be observable after the fact. Thus, in an environment characterized by informational asymmetry, the principal should be wary of reading too much into the agent's reputational signal. Reputation, therefore, may have little power to enforce contracts in environments characterized by the informational asymmetry that shapes the payoff matrix. In this situation one may not be able to build a reputation because the agent is not "honoring trust."

The Decision to Build a Reputation

In balance sheet terms, a firm's reputation can be viewed both as an asset and a liability. On the asset side, the firm now owns (in a sense) the reputation it has built in the future. This value comes from the expected present value of sales of its products. While the liability would be the present value of losses due to service in the future. Thus our definition of a corporate reputation:

1) A firm can have several types of reputations, reputations of individuals within the firm.

2) A firm builds a reputation for itself (e.g., customers, creditors, suppliers).

3) The building or maintaining of a reputation is a short-run, presumably in the example given, whether to build or maintain the reputation as a capital budgeting decision.

4) A firm's reputation can also be maintained. An agent's long-term desire to maintain the reputation of the principal in the short-term can take the form of a reputation:

A reputation is a behavioral trait that is consistent with a firm's desire to earn future implicit contractual enforcement rights.
The Decision to Build a Reputation

In balance sheet terms, a firm's reputation at any time can be viewed as both an asset and a liability. On the asset side is the increased value of the implicit claims sold by the firm now and in the future. While on the liability side is the present value of honoring these claims in the future. For example, consider a durable-good producer that has built a reputation for superior post-sales service. The present value of the price premiums that the firm receives on sales of its product as a result of the reputation would be an asset. While the liability would be the present value of the cost of providing superior after-sales service in the future. Thus our discussion so far has identified four key characteristics of a corporate reputation:

1) A firm can have several reputations for different attributes, not to mention the reputations of individuals within the firm that may be distinct from the overall firm reputation.

2) A firm builds a reputation by demonstrating a consistent mode of behavior to its stakeholders (e.g., customers, creditors, shareholders, etc.).

3) The building or maintaining of a reputation can require net expenditures in the short-run, presumably in the expectation of net revenues in the long-run. Thus the decision whether to build or maintain a reputation at any time can essentially be viewed as a capital budgeting decision.

4) A firm's reputation can act as an implicit contractual enforcement mechanism: An agent's long-term desire to maintain its reputation may induce it to act in the interest of the principal in the short-term.

These four characteristics, in turn, prompt the following definition of a corporate reputation:

A reputation is a behavioral trait. A firm builds a reputation by demonstrating a consistent mode of behavior through a series of contractual situations. Once built, a reputation increases the value of implicit claims sold by the firm to stakeholders. Thus a firm's desire to earn future profits by maintaining its reputation may act as an implicit contractual enforcement mechanism.
For example, a firm with a reputation for creditworthiness will be able to sell its subordinated debt at a premium compared to less reputable firms. This premium represents the value of an implicit claim. By paying the premium creditors buy an implicit claim that the reputable firm will make timely interest and principal payments (assuming that, in the event of default, these creditors would be unable to recoup their losses from the residual assets of the firm, thus making their claim explicit). Mortgage-bond holders, on the other hand, need not be as concerned with the firm's reputation for creditworthiness because their claim is explicit: in any outcome they recoup their investment.

The Power of Reputation

But, from a practical perspective, how powerful a force is reputation in contemporary business environments? Can a manager's desire to build or maintain a reputation be relied upon consistently to enforce business contracts? If it can, then there seems little need to consider other non-material, opportunism-based notions of rationality: the ill effects of opportunism will be successfully reined in by agents' desire to build and maintain their reputations. There will be little or no need for ethics, or more precisely an intrinsic commitment to honor trust, as a constraint on behavior.

Sadly, one does not have to look far to find ample evidence that reputation is not enough: as a solution to agency problems, the "reputation solution" is no solution. Enron, World-Com, and Tyco represent just the tip of the agency-problem iceberg. One only needs to read the financial press or flip through a business-ethics casebook to find many similar scenarios. In all of these cases, implicit contracts were not adequately enforced by the desire of agents to preserve either their own reputations or the reputation of their firm. The economic mechanism of reputation is not enough. Financial-economic rationality does not naturally result in optimal equilibria, what economists call "first-best" outcomes. Regardless of what happens in reality, even in finance theory there is room for ethics.

Thus ethical behavior among participants in a financial contracting situation can be viewed as a type of implicit contractual enforcement mechanism. Note that ethical behavior — such as 'honoring trust' in Figure 3 — is not irrational or suboptimal since it leads to a stable cooperative equilibrium between principal and agent. Of course this ethical equilibrium relies on the principal 'trusting' the agent to cooperate. And indeed this is the ethics challenge in business: to instill honest and trustworthy behavior among market participants. If this challenge is met, then it's a win-win situation: both principal and agent flourish in a self-perpetuating cooperative relation.

LEVEL TWO INTEGRATION

Instructors who adopt level one integration will make their students aware of the fact that ethical value judgments are unavoidable in finance. The next logical step is to provide students with some practical experience in dealing with ethical dilemmas. One way to do this is to provide case studies or vignettes that illustrate the ethical issues that are relevant to finance. For example, Robert F. Bruner's Case Ethics: The Rationality of Virtue (2004) provides a good example.

LEVEL THREE INTEGRATION

My finance department offers a course that is devoted entirely to an analysis of ethical issues in finance. This course is taught by a faculty member who has a strong background in business ethics. The course is designed to provide students with a comprehensive understanding of ethical issues in finance. The course covers a wide range of topics, including the legal and regulatory environment, the role of ethics in decision making, and the impact of ethical behavior on financial outcomes. Students are expected to engage in a number of practical exercises, such as role-playing simulations and case studies, to help them develop their ethical judgment skills.

CONCLUSION

This article begins from the premise that ethical issues are an integral part of the finance curriculum. The next logical step is to provide students with an opportunity to engage in practical exercises that will help them develop their ethical judgment skills. The article also argues that financial education should be about more than just the numbers. It is about understanding the ethical implications of financial decisions and taking responsibility for the outcomes.
orthiness will be able to sell its reputable firms. This premium the premium creditors buy an interest and principal payments would be unable to recoup their claim explicit. Mortgage-led with the firm’s reputation for any outcome they recoup their mortgage-interest and principal payments would be unable to recoup their claim explicit. Mortgage-orthiness will be able to sell its reputable firms. This premium; the premium creditors buy an interest and principal payments would be unable to recoup their claim explicit. Mortgage-led with the firm’s reputation for any outcome they recoup their.

A powerful force is reputation in one’s desire to build or maintain a contract? If it can, then there opportunism-based notions of selffully reined in by agents’ desire ttle or no need for ethics, or more constraint on behavior. Evidence that reputation is not a solution” is no solution. Enron, incy-problem iceberg. One only ever ethics casebook to find many of its were not adequately enforced stations or the reputation of their own. Financial-economic oria, what economists call “first- even in finance theory there is great financial contracting situation can be a mechanism. Note that ethical: irrational or suboptimal since it incipal and agent. Of course this e agent to cooperate. And indeed trustworthy behavior among win-win situation; both principal elation.

make their students aware of the nance. The next logical step is to provide students with some practical guidance on how to make the best decision in any given situation. This can be achieved in two stages.

First, students must have some background in basic ethics theory. They may already have this background from a class in business ethics or moral philosophy, but to ensure they have the necessary intellectual tools to make sound moral judgments the instructor could assign some basic readings on ethics theory. Chapters Four, Five, and Six of Finance Ethics: The Rationality of Virtue provides a summary of basic ethics theory as it relates to finance.

Second, assign finance case studies that will enable the students to apply the ethics theory to specific decision situations in finance. Many case sources are available (see, for example, http://www.ibe.org.uk/). The instructor may choose to make up his or her own case vignettes (see Appendix One for an example). Or some already assigned finance cases that involve behavioral choices could be discussed from the perspective of ethics. For example, Robert F. Bruner’s Case Studies in Finance (2002) text provides many ostensibly finance cases that can also be viewed from an ethics perspective. In this context, see also Hess and Strands, "Teaching Ethics in Investment Classes: A Series of case Vignettes" (2004).

LEVEL THREE INTEGRATION

My finance department offers a class entitled "Ethics and Behavioral Finance". The class is devoted entirely to an analysis of the behavioral foundations of finance from both a normative and positive perspective. The offering of this type of class represents level three integration.

This level of commitment to financial ethics obviously involves a significant departmental resource allocation. Appendix Two is the syllabus for the class mentioned above. Other instructors may choose different approaches. But whatever the approach chosen, the class should benefit from the ever-broader literature on behavioral finance, business ethics, and indeed financial ethics, as reflected in the assigned readings of the syllabus in Appendix Two.

CONCLUSION

This article begins from the premise that there should be some integration of ethics into the finance curriculum. Three possible levels of integration are presented, each requiring a progressively greater commitment of departmental resources.

Level One Integration merely makes students aware of the normative content of the behavioral assumptions that underlie finance pedagogy. Level Two Integration builds on level one by ensuring students have a grounding in ethics theory, and by applying that theory to specific decision situations in finance. Level Three Integration requires the greatest commitment of departmental resources. It involves establishing a course specifically on financial ethics.
APPENDIX ONE

WORKSHOP ON FINANCIAL ETHICS

WELCOME: Please read the following case vignette carefully; then answer the questions below briefly in the space provided.

You recently landed your dream job. You are working as a junior financial planner for Smith and Jones Wealth Management Inc., the largest financial planning firm in SLO county. You currently have several clients, mostly elderly retired, and your job is to advise them on the best investment vehicles in which they should invest their savings.

Mostly you recommend mutual funds, which are diversified pools of stocks. Mutual funds are currently the most popular type of investment vehicle in the United States. Currently you deal with two basic types of mutual fund. Growth Funds, which can be risky in the sense that returns generally vary over time, but they offer the chance of high returns in some years; or Income Funds, which are less volatile but offer returns that just match market averages.

Given that your clients are elderly and thus rely on investment returns for a steady income, the rule-of-thumb implies that they should be in less risky investments, namely Income Funds. Also, given that Income Funds are more passively managed they tend to charge lower fees, thus they are slightly cheaper for the client.

So, all else being equal, this sounds like a no brainer. Put your clients in the Income Funds. But all else is not equal. Unlike the Income Funds, the Growth Funds offer what is generally called 'directed brokerage'.

Directed brokerage is a sales commission that the Growth Funds will pay you for putting your client in their fund. This also partly explains why the fee charged to your client is higher for the Growth Funds: your client is basically paying an extra fee to you when they pay the higher commission fee to the Growth Fund. Of course the client does not know this, unless you choose to tell them.

So, in making your choice of which fund to recommend to your clients you are faced with a dilemma; what economists call a 'conflict of interest'. Unless you and the client just happen to get lucky and the Growth Funds do well, rule-of-thumb would indicate that the client is better served by you putting them in the Income Funds: the Income Funds charge the client lower fees and offer a more stable return over time.

But you personally will make more money by recommending the Growth Funds. A large part of your income comes from commissions, and you can virtually double your commission income in any one year by consistently recommending Growth Funds over Income Funds. SLO county is an expensive area and you're struggling to buy a house. You'd also really like to buy a more prestigious car to go with your 'professional' status.

Now please answer the following:

1) Which type of funds will you recommend, Income Funds, or Growth Funds? Why; please briefly state your reasoning or on economic reasoning.

2) Regardless of your answer above, why 'wrong' with recommending the 'wrong' type of fund? Are there any reasoning or economic reasoning.

3) As you may know, the Securities and Exchange Commission (SEC) investigated broker behavior, and discovered that brokers were actually recommending the funds that they were paid more by. If you were one of these brokers, and that year you were one of these brokers, and that you were paid more by the Growth Funds, might you try to justify your choice by:

4) Returning to your answer above, would your answer change your education or personal life decisions?

Thank-you for participating in our workshop on financial ethics. To answer these last few questions. You might want to turn this in on your way out; and:

5) Has our discussion today affected your way of thinking about Income versus Growth Funds, and mutual funds?

6) In light of our discussion, how would you feel about being a financial planner? To whom do you feel responsible?

7) Why do you think it is that we, as financial planners, do not know this, unless you choose to tell them.

'Struggling to buy a house.'

You'd also really like to buy a more prestigious car to go with your 'professional' status.
Now please answer the following questions:

1) Which type of funds will you recommend to your elderly clients, Growth Funds or Income Funds? Why; please be as specific as possible.

2) Regardless of your answer to Question 1, what exactly do you think would be 'wrong' with recommending the other type of fund? Is your answer based on moral reasoning or on economic reasoning?

3) As you may know, the Securities and Exchange Commission (SEC) recently investigated broker behavior, and found that -- in the language of our scenario -- many brokers were actually recommending the Growth Funds to elderly clients. Imagine you are one of these brokers, and that you are being interviewed by an SEC investigator. How might you try to justify your choice of the Growth Fund?

4) Returning to your answer to Question 1. What, if any, general principles from your education or personal life did you use as guidance in making your choice?

5) Has our discussion today altered or modified in any way your original choice of Income versus Growth Fund, and the reasons for your choice.

6) In light of our discussion, how would you define your 'professional' obligation as a financial planner? To whom do you owe your primary obligation, and why?

7) Why do you think it is that the SEC identified so many brokers choosing the 'Growth Fund' in the 'real world'? What will you do in the real world?
APPENDIX TWO
ETHICS AND BEHAVIORAL FINANCE, SYLLABUS

COURSE OBJECTIVE: This course will cover contemporary theoretical and empirical issues in behavioral finance and financial ethics. Topics may include: agency and signaling theory, reputation models, game theory applications, ethics theory and applications in finance. These topics will be applied to realistic situations in financial services, investment banking, securities analysis, etc. This course will also address the content and justification of the Codes of Ethics supplied by the governing bodies of the CERTIFIED FINANCIAL PLANNER, and CHARTERED FINANCIAL ANALYST designations.

REQUIRED TEXTS:
1) Ethics in Finance, John R. Boatright, (Blackwell, 1999)
2) Finance Ethics, John Dobson, (Univ. Press, 1997)
3) Ethics and Behavioral Finance, (Readings Packet)

COURSE SCHEDULE
Module I: THE NOTION OF RATIONALITY IN FINANCE:

Week Two 9/27 and 9/29:
m3.Boatright, pp. 46-52: "Agency Theory"
m4.Dobson, Ch. 3: "Is Reputation Enough?"

Module II: EVIDENCE FOR AND AGAINST THE 'RATIONAL' AGENT.

Week Three 10/4 and 10/6:
Readings Packet: (All readings from Financial Analysts Journal) m6.Thaler, "The End of Behavioral Finance"

REFERENCES
MODULE III: ALTERNATIVE NOTIONS OF RATIONALITY

Week Five 10/18 and 10/20: Modern Ethics Theory
m5.Boatright, Ch. 1, "Financial Ethics: An Overview"
m6.Boatright, pp. 53-61 "Philosophical Ethics"
w7.Boatright, pp. 182-198, "Ethical Implications"

Week Six 10/25 and 10/27: Classical (Post-modern) Ethics theory
m8.Dobson, Ch. 7, "Which Rationality?"
m9.Dobson, Ch. 8, "Practical Rationality"
w10.Dobson, Ch. 10, "Toward a New Finance Paradigm".

MODULE IV: PRACTICAL IMPLICATIONS OF ETHICS IN FINANCE

Week Seven 11/1 and 11/3:
m1, m2, m3.CERTIFIED FINANCIAL PLANNER(Grp. 1), CHARTERED FINANCIAL ANALYST(Grp. 2), and CHARTERED PUBLIC ACCOUNTANT(Grp. 3); Codes of ethics, content and justification.
w4.Boatright, Ch. 3, "Ethical Issues in Financial Services"
w5.Boatright, Ch. 4, "Ethical Issues in Investment Decisions"
w6.Boatright, Ch. 5, "Ethical Issues in Financial Markets"

Week Eight 11/8 and 11/10:
m7.Dobson, Ch. 4, "Toward Reconciling Ethics and Finance"
m8.Dobson, Ch. 5, "Ethics in Financial Practice"
w9.Dobson, Ch. 6, "Some International Implications"
w10.Dobson, Ch. 9, "Some Gender Implications"

REFERENCES