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Corporate Governance and Ethics within Financial Institutions –

Coping with a major fault line of the current economy.

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"'Love,' says my Lord Rochefoucault, 'is commonly succeeded by ambition; but ambition is hardly ever succeeded by love.' That passion, when once it has got entire possession of the breast, will admit neither a rival nor a successor. To those who have been accustomed to the possession, or even to the hope of public admiration, all other pleasures sicken and decay."
Adam Smith in The theory of moral sentiments, 1759, Chap. II: Of the origin of Ambition, and of the distinction of Ranks.

Abstract

With the last financial crisis in the background, this article examines to what extent an agent's intrinsic motivation to comply with internalized ethical standards depends on corporate governance mechanisms and principles on the one hand, and on external interventions that might crowd them out on the other hand. We then propose certain ways to alleviate this problem.
Key words: Corporate Governance, Agency theory, Intrinsic and extrinsic motivations, Self-Determination Theory, Compensation, Regulation, Ethics, Financial crisis

1. Introduction

This article belongs to the growing literature that underlines the importance of psychological mechanisms in explaining the rational that people bring forward to justify their decisions and their behaviours in an institutional context. For example, A. Bandura, a Canadian sociologist, proposed ten psychological mechanisms to explain the moral disengagement of individuals in the context of death penalty (Bandura, 1999, 2002). Pauchant *et al.* (2015) applied this model to the financial crisis context to demonstrate the extent to which these mechanisms may have undermined the morality and ethics of investment bankers who participated in the subprime sales and securitization process.

In the first part, after reconsidering the traditional economical, monetary and regulatory reasons generally advanced to explain the recent financial crisis, we analyse the premises of corporate governance theory and the principles that may have played a role in the ethical crisis within the financial sector.
In the second part, we will then give a behavioural and motivational account of the crisis that complements the arguments presented in part I. We will build on the analytical framework developed by Bruno S. Frey in an economics and governance context, in particular the eight propositions presented in his 1997 book *Not just for the money*, and discuss the relevance of his empirical evidence for the financial crisis. We will thereby highlight the crowding-out effects' consequences on ethical attitude and behaviour of financial institutions' top executives, traders, and investment bankers.
In the third part, we will suggest favourable conditions under which intrinsic motivations and hence internalized ethical behaviour at individual level could be re-activated in a revisited multi-principals and multi-agents corporate governance perspective

2. The Premises of Early Agency Theory and Corporate Governance

Raghuram Rajan (2010), the current governor of the Indian Central Bank, has put forward several "fault lines" of the world economy that, according to him, were already there in 2005 and led two years later to the turmoil we are still experiencing. Examining in particular the financial sector, he points out that "its failings in the recent crisis include distorted incentives, hubris, envy, misplaced faith, and herd behaviour". This paper will now try to pin down the mechanics if these failings.

• Bank capital structure might be seen as a Governance mechanism.
One characteristic of the financial institution is to be highly leveraged and that may be a problem: in the banking sector, leverage is not "a source of financing" but rather a "factor of production" and so," Banks will deploy the cheapest factor in their production function" (Mehran, Morrison, Shapiro, 2011) as a consequence. Thanks to State deposit insurance, depositors are not too demanding in terms of return, and short-term debt becomes a cheap source of capital, leading to another specificity: the maturity gap between assets and liabilities. In fact, major banks had a high short-term leverage before the crisis.
To what extent does this peculiarity interest us from a Governance perspective?
First, "with leverage, shareholders and their agents prefer riskier bets than if the firm had no debt because the payoffs from leveraged bets are asymmetric" (Tung, 2011). In fact, the possible high-risk strategy gains have no upper limit, whereas the possible losses coming from a bad high-risk strategy have a floor: the maximum amount shareholders may loose corresponds to their investment and the remaining losses will be accounted for by the bank's creditors. So it is traditionally thought that while shareholders and agents tend to prefer volatility and short-term perspective, debt-holders and regulators prefer the contrary (Mehran, Morrison, Shapiro, 2011). The last crisis may give some weight to this argument.
Second, the race toward more debt or hybrid securities at the expense of more qualitative equity capital (tier one ratio) may worsen the crisis and jeopardize a bank's survival (ibid).
Together with the pay-for-performance principle, these structural characteristics of banks (high leverage and lower capital quality) could explain the observed high risk-appetite of shareholders and the incentives they then gave to their agents to go in that direction over the period 2000-2008.

• The pay-for-performance principle is supposed to make divergent interests converge.
One important premise early agency theory is its prediction "that compensation policy will tie the agent's expected utility to the principal's objective." (Jensen and Murphy, 1990): as the

principal's objective is to get the highest possible return on investment, mechanically, the relation between agent's pay and firm's performance is positive and statistically significant (ibid.). This prediction, even if the relation's magnitude was not so high (ibid.), led to design compensation packages giving a large importance to the variable part of compensation and including convex devices whereby there is no upper limit on gains but where penalties are lower bounded.
As mentioned by Bebchuck and Fried (2003), this "optimal contracting approach" may be flawed because "some features of pay arrangement seem to reflect managerial rent-seeking rather than the provision of efficient incentives." Even if this phenomena should not be generalized, in the pre-crisis period some managers did extract rents as explained by Bebchuk, Cohen and Spamann (2010). So during many years, both shareholders and top-executives gained, but while the first ones lost everything in 2008, the second ones kept also everything (there were no claw back clause i.e. the obligation for the manager to give back her benefit in case of financial profits lower than expected within a certain period of time after it has been paid). Second, they explain the short-term orientation of their decisions through the quasi-immediate and regular vesting and exercise of their options or the sale of their equity positions.

• The separation of ownership and control triggers monitoring agency cost and requires a specific supervision and regulatory framework.
Another premise of early agency theory is the separation of ownership and control (Berle and Mean, 1932) and the potential conflicts of interest that may arise from this separation.
As underlined by Jensen and Meckling (1976), it may happen that the agent fails to maximize the value of the firm because he/she may have "aberrant activities" that can damage the "welfare of the principal" (ibid). The result is that the principal is constrained to incur in what is called "monitoring agency costs" (ibid) to be sure his/her interests are prioritized and clearly taken into account in the managerial decisions made by the agents. As a consequence of this rent- seeking model and of financial institutions' increasing complexity in scope and size (Mehran, Morrison, Shapiro, 2011), the financial and banking sector is a highly regulated one. Nevertheless, the Group of Thirty (2013) proposed to lay the emphasis on qualitative supervision and collaboration rather than on quantitative regulation. We shall discuss this point in the last part and see how the motivational theory may explain the impact of this change of perspective on the motivations of agents.

3. How extrinsic motivation might crowd out intrinsic motivation.

Motivations are of two natures, intrinsic and extrinsic. In one of his first article, Deci, building on Berline (1966), Hunt (1965), and White (1959), originally defined intrinsic and extrinsic motivations as follows:
"A person is intrinsically motivated if he performs an activity for no apparent reward except the activity itself. Extrinsic motivation, on the other hand, refer to the performance of an activity because it leads to external rewards." (Deci, 1972).
These two types of motivations form what we call a motivational level, which differs across individuals: to the quantitative argument (individuals have a certain amount of motivation), Deci and Ryan introduced a very important qualitative indicator for motivation (motivations can be intrinsic or extrinsic). These qualities do not play the same role and are not triggered the same way.
In 1997, Bruno Frey added that: "Human motivation is not restricted to monetary incentives. In addition to the extrinsic motivation induced from outside, intrinsic motivation is also crucially important. (…) Intrinsic motivation is of *great importance* for all economic activities. It is inconceivable that people are motivated solely or even mainly by external

incentives". In fact, individuals do not work only to get a compensation but are also motivated by the sense that this particular work brings to their life and the perceived fulfillment that they may experience in their job. Both motivations interact and one may crowd-in or crowd-out the other under certain circumstances. In fact, "the use of monetary incentives *crowds out* intrinsic motivation under identifiable and relevant conditions (*crowding out effect*)." (Frey, 1997). So, to come back to our context (the financial crisis), we argue that agents (we consider top executives, traders or investment bankers of large financial institutions) are motivated by intrinsic and extrinsic factors and that the two categories may interfere. We consider that agency theory focuses mainly on compensation matters to influence the agent and to make the interests of principal and agent converge. We observed in fact the increasing importance given to compensation since the 1990's: the equity part compensation in the total one of the top-five executives from the S&P 500 firms increased from 37% in 1993 to 55% ten years later (Tung, 2011) and we argue that this trend played a great role in the decreasing moral mindset of the financial industry. "Extensive research shows that extrinsic motivation/goals/values generally have a negative impact on well-being, while intrinsic motivation/goals/values generally have a positive impact on well-being." (Gagné et Forest, 2008). Moreover, "other external interventions such as commands or regulations can drive out intrinsic motivation" (Frey, 1997).

The Group of Thirty (Oct. 2013) acknowledged that too much emphasize has been laid on regulations and rules setting such as "risk-based capital, liquidity, resolution, and risk management" (ibid, p. 11), and "not enough attention has been placed on 'softer' issues that rules alone cannot address, such as enhancing supervisor-board relations to improve supervisor and board effectiveness, or on the culture of firms, which many observers consider to be contributors to the financial crisis" (ibid, p. 11). They argue that "supervision is much more than checking compliance with rules and regulations; it deals with *behaviours (emphasize added)*, which regulation often cannot." (ibid, p. 14)

In a nutshell, it seems that, to a certain extent, both compensation schemes and excessive external intervention (regulation) crowded out the intrinsic ethical motivation of agents. We shall now go through the 8 situations mentioned by Bruno S Frey whereby the crowding out effect may be active, discussing each time whether it applies to our context.

• Personal relationship

"The more personal is the relationship between principal and agent, the more important is intrinsic motivation." (Frey, 1997)

We can argue on the one hand that the world of finance has become a more and more depersonalized world whereby a great majority of transactions (for example the trading of equities) go trough an electronic platform where the agent does not even know the counterpart (OTC trading or high frequency trading that represents for example 50% of all the transactions on the CAC40 index). This fact puts a crude light on the lack of interpersonal relationship and hence the decrease in intrinsic motivation of the actors. Financial market-based impersonal intermediation replaced banking-intermediation.

On the other hand, we may argue that given the increasing short tenure of shares by the principals -individuals and institutions- (the average tenure on the NYSE and Nasdaq is estimated to be around 6 months) personal interactions between the principal and agent have decreased. Finally, in the US and more generally in Common Law countries, the ownership model is a widely-held system of participations contrarily to the European model of more concentrated ownership. This diversification does not help to create relationships and commitment on the long-term on shareholders' side.

• Type of activity

“The more interesting the task is for the agents, the higher their intrinsic motivation to perform well, and the more an external intervention diminishes perceived self-determination and self-evaluation, and therewith the intrinsic motivation.” (Frey, 1997)
We can reasonably suppose that the task of a trader or an investment banker is interesting, that they decide on a free basis to do this job, socially and economically rewarding and so that the proposal may apply. But the massive external interventions we observed since the beginning of the 21st century (increasing controls, audits, regulations -SOX, Dodd-Franck, Basel III-), by crowding out the intrinsic motivation, let the extrinsic motivation (namely compensation) play the big role, and might trigger the unethical practices we observed on multiple occasions. In fact, the locus of control has been externalized leading probably to less « self-determination » and « less self-evaluation ».

• Participation
« The more extensive the agent’s participation possibilities are, the more an external intervention shifts the locus of control outwards, thus crowding out intrinsic motivation. » (Frey, 1997)
In this case, we shall argue that a trader has a high possibility of self-determination and hence participation. In theory, she can freely determine the trading strategy she wants to follow to generate profits providing she respects some risks limits. In this context, participation suggests empowerment and delegation whereby an interference (like increased controls, norms, procedures that flourished) may one more time reduce the intrinsic motivation and so the ethical sense of responsibility among others.

• Uniformity
“The more uniform the external intervention, the more negatively are those agents affected who have above-average intrinsic motivation. They feel that their competence and involvement are not recognized by the principal and therefore adjust their intrinsic motivation downwards.” (Frey, 1997)
We can reasonably argue that the new regulations decided on an international scale tends to be uniform in its application (the capital ratios, the risk weights applied to the assets, stress tests philosophy beyond the various possible methods, …) are globally the same for all the banks. These legal requirements may have a perverse effects on the « good » institutions since all the banks have to enforce the rules, do they behaved well or not - in fact not *all* the banks did enter the subprime markets, not *all* the banks structured Abacus-liked products, not *all* the traders are rogue traders, etc ….
The same could be said about the compensation issue. We are not saying of course that the new decisions to monitor, limit or reduce some compensation characteristics are not welcome; on the opposite, we strongly support these new initiatives. We just want to pay attention to the limits of the exercise induced by the crowding out effect on intrinsic motivation of the most « ethical » bankers.

• External intervention: reward versus command
“External intervention via rewards crowd out intrinsic motivation less than regulations used for the same purpose.” (Frey, 1997)
With reward there is still “a certain amount of freedom in the intensity of responding”; it is not the case when the employee receives a punishment or a command.” (Frey, 1997)
The new regulation has been enacted in reaction to the excesses created during the crisis, and in order to establish a trustworthy business environment again. It may be perceived as punitive and negative, and it is in fact. We may ask if it would not be worth to trigger an ethical behaviour by others means that are not deterrent or too much rewarding. Isn’t there a

more positive way to increase the intrinsic motivation of the agents and to arouse their ethical sense of responsibility? We suggest to foment an increased awareness and « awakeness » as explicitly underlined by the Group of Thirty (2013).

• Contingency of rewards on performance

"The more closely a reward is contingent on the performance desired by the principal, the more is intrinsic motivation crowded out." (Frey, 1997). Intrinsic motivation is substituted by extrinsic motivation.

The model of pay for performance is the governance model adopted by the vast majority of the firms and has been evidenced by empirical studies (Tung, 2011). By crowding out the intrinsic motivation, we can rationally ask to what extent this model is not one of the main causes of the financial crisis.

"A vignette study showed that a high proportion of performance-contingent pay was related to a larger decrement of intrinsic motivation, which in turn negatively affected performance. (Weibel et al., 2007, in Gagné et Forest, 2008). Others studies were not so assertive; that shows that the first results go in the "right" direction for us but further researches are needed.

• Hard regulation versus soft regulation

« Hard regulation crowd-out intrinsic motivation, soft regulations tend to leave it unaffected and may even crowd it in. (…). Hard regulation involves enforceable commands; soft regulation comprises non-enforceable directives implemented by agreement and without treat of punishment". (Frey, 1997)

A great part of regulation put in place to foster more morale in business and ethics in financial institutions, is on the « hard regulation » side. We can distinguish between the regulatory measures that aim at making financial institutions more robust, sound and resistant to liquidity crisis, at preventing the systemic risks and at mitigating risks in general (higher tier one capital ratio that aims at increasing the quality of banks' capital; the creation of clearing houses to control the derivatives OTC transactions in order to monitor the risk takings; the separation of the proprietary trading from the rest of the activities or the high frequency trading regulation are some of the examples we can quote): these measures are proposed in a prudent (down-side risk adverse) perspective to make the system more stable and apt to react rapidly. Institutions have to adjust their balance-sheets, restructure their organizations to adapt to the new requirements. We do not take this kind of regulation into consideration because once implemented, they will become business as usual and routine; they will define the limits of the general framework within which banks should do business and should operate. We rather suggest that the problem of "hard regulation" lies in the increasing numbers of reporting, audits, stress tests, diary risks assessments required by the numerous regulatory authorities (local, national, supranational, …). These daily pressure comes from two facts: first from the increasing complexity of financial products (structured products and securitization process, derivatives…), and the increasing size and scope of banks (Mehran, Morrison, Shapiro, 2011), and second from the generalized mistrust towards banks. Both factors make the controls more stringent and thus may discourage the agents on a daily basis.

On the reverse, ethics and trust fostering culture and values of an institution are more on the « soft-regulation" side, that is why we strongly recommend to work on this side of the problem. We could deduce that the legal way to tackle the morale crisis we undergone is perhaps not the right way to solve the problem; worst, the increasing controls and pressure put on the bankers could be suspected of making it more acute.

"Individuals who are forced to behave in a specific way by outside intervention, feel over justified if they maintain their intrinsic motivation (over justification effect). … Individuals

reduce the factor that they control themselves, that is, intrinsic motivation; … behaviour becomes more extrinsically guided.” (Frey, 1997).
So that the “crowding out effect” added to the “over-justification effect” of hard regulation as defined above may combine to lower the intrinsic motivation further. And the next crisis could not be far away.

• Message implied by the external intervention
“The more strongly an external intervention implies an acknowledgment of the agent’s intrinsic motivation, the more strongly it fosters intrinsic motivation.” (Frey, 1997) To understand this proposition, let’s look at the example given by Frey in his book: in the economics of crime, “in so far as *all* costs imposed by crime were paid, the criminal act should not be morally condemned. To behave legally or illegally would solely be a matter of calculating benefits and costs.”
We may draw a parallel with the monetary and legal solutions proposed after the crisis:
First, the bail-out of banks that were « too-big-to-fail »: American and European governments sustained their national banks by lending huge amounts of money in order to avoid a bankruptcy chain effect as if it was sufficient to pay to be relaxed. The measure was necessary to avoid a more widespread disaster, but we can argue that it gave a bad signal to financial institutions for the future as there is no deterrent anymore to behave excessively or with greed. It created a moral hazard that Bagehot had already pointed out in the XIXth century.
Second, several rogue traders and bankers so far have not been sentenced to jail but rather fined within legal proceedings, like their employer who negotiated their fines to avoid prosecution. The problem has been well explained by Sandel (2013): the fine may become a fee in fact, that is to say a certain amount of money to pay in order to be able to go on doing what is in fact forbidden or unwanted or undesirable. The fee becomes an internalized perverse rule of the game.

4. Possible avenues for change.

• Financial institutions should put soft issues on their agendas.
In order to strengthen the intrinsic motivations or get them back, the challenge consists thus in determining how to turn an external intervention perceived as *controlling* into one perceived as *supportive* (Deci and Ryan use the name “*informative*” for the same concept). *Self-determination theory* (SDT) argues that the supportive conditions to develop intrinsic motivations are those fostering the three basic needs of individuals, namely: autonomy, competence and relatedness. The proposals we make bellow to fulfill the three needs aim at developing both individual ethics and interpersonal or institutional one.
- Foster moral autonomy through self-control: get incentives right.

How to motivate the agent to be morally autonomous? Through the right incentive based on the right performance indicators. The question becomes then how to compensate rightly several tasks and foster one soft task (ethical behaviour) that is difficult to measure, compared to a hard one, much easier to quantify?
We may adapt the model developed by B. Sinclair-Desgagné (1999) to ethical motivation. Let’s consider an agent whose functions include two tasks: A (financial product sale) and B (ethical behavior). “Task A can be routinely monitored, while task B can be subject to contingent control. The principal/manager would control task B only when performance on task A is high (consider a trader for example whereby we can measure objectively the profit generated but less easily the ethics of the strategy chosen). Payments are such that the agent’s expected utility is higher when an audit on task B happens. On the other hand, if the contingent audit finds out that task B seems to have been neglected, then the agent receives a payment that is smaller than what he would have obtained without this control”, (adapted

from Sinclair-Desgagné, 1999). By linking this way the performance review of both tasks, the principal can "direct the allocation of the agents' attention among their various duties" (Holmstrom and Milgrom, 1991). This model presents the advantage to be able to take into account and reward the ethical behaviour that the principal should look for.

- Educate to virtue and practice virtue

To act, decide, and behave ethically is to be virtuous: the virtuous person seeks to act in good faith, and try to combine his/her own interests with the others' one. To behave ethically means then to take into account the plural interests of all stakeholders of the bank, and not only the shareholders' ones.

The stakeholders of banks are first the society (through its customers: its depositors, its SMEs, its large firms, its poors looking for affordable payment's means, …), the government (through the insurance deposit), the environment (for example, international project financing in emerging markets should operate within certain conditions of respect of local communities and environment pollution).

We argue with Sandel who builds on Aristotle and Rousseau (2013, p. 137) that virtue is not "a commodity that is depleted with use": on the contrary, we need to practice it so that it can grow and spill over. Hence the importance of integrity and exemplarity of the institutional leaders (Selznick, 1957) and the dominant coalitions (Cyert and March, 1963) or the small worlds of Corporate Governance (Kogut, 2012): in short, the tone at the top (Schwartz, 2013).

That is why we argue that corporate governance envisaged as the good government of institutions has a crucial importance and that premises must change.

The elites will have to work on culture and values of their banks:

"*Values and culture may be the keystone of FI governance because they drive behaviour of people throughout the organisation and the ultimate effectiveness of governance arrangements. Culture is the internal compass that guides individuals' behaviour when no one is looking. It involves soft features that defy quantitative measurement, but they cannot be ignored*." (Group of Thirty, 2012, p. 76)

The calls for a change in culture are numerous and mean that questions such as "how do we want to define our core business"," with which philosophy and values do we want to operate" are key questions.

- Foster moral sentiment and relatedness

Between the institutional and the individual levels, there is the interpersonal level of interactions among individuals within the firm.

Intrinsic motivations need the right tone from the top as seen above, but require also the effective translation of words into acts and we rarely act alone within institutions: relatedness concern should be put on banks' agenda. That is why the Group of Thirty (2013) insists so much on the quality of supervision through a fair and true dialogue between board, supervision authorities and top-management.

This dimension of ethics may be explained by the fact that individuals use a mechanism of empathy towards the others as explained by Adam Smith in his Theory of Moral Sentiments (1759). The problem is that these moral sentiments may have been subdued by extrinsic motivational factors during the pre-crisis period and since then too (due to the extended regulations). All the mechanisms explained in the first part may have reduced the emotional capacity of the agents and their disposition for virtuous behaviours.

In the third chapter of TMS (Of the corruption of our moral sentiments), Smith explains that we are looking for admiration and approbation and that it is easier to admire or be admired because of our wealth and fame rather than because of our virtuous character:

"*This disposition to admire, and almost to worship, the rich and the powerful, and to despise, or, at least, to neglect persons of poor and mean condition, though necessary both to establish*

and to maintain the distinction of ranks and the order of society, is, at the same time, the great and most universal cause of the corruption of our moral sentiments." (TMS, I. 3. 28-29)
The intrinsic motivation for business ethics having been crowded out, benefits are looked for beyond ethical motivations and "effort is put into socially unproductive endeavours" (Frey, 1997) and even socially damaging behaviours.
For example, the concept of social dividend is an important one for our arguments: that implies a change in banks' business model since they let some branches be unprofitable to be coherent with their social mission but care that globally the bank be profitable to survive. These saving banks accept to sacrifice local profitability to reach others superior moral goals and maintain this "relatedness" with communities and social net: they introduce moral reasoning in market reasoning (Sandel, 2013).
Investment banks could take the same road: we know that speculation on commodities destabilizes the local producers in emerging countries, that most of derivatives markets are not based on search for protection but are done in a speculative perspective. Introducing "relatedness" and moral reasoning would imply that severe changes be introduced in the business models of the banks to curve speculation. A stated by the Group of Thirty 2012's statement: *"Culture is closely aligned with business model. Management, boards, and supervisors should carefully consider whether the business model reinforces a healthy culture."*

• Secondly, to change the decisions top-management and governance bodies take, change the premises of Corporate Governance in three ways.

- <u>Pay for balanced and sustainable performance, as a prudent principal would do</u>

The pay-for-performance practice designed at the beginning to align shareholders' interests with those of the top-executives, led to some excess qualified of "self-serving managerial rent extraction" (T Randall, 2008).This principle in fact has been turned into a "pay-without-performance" practice (Bebchuck and Fried, 2004): *"Flawed compensation arrangements have been widespread, persistent, and systemic, and they have **stemmed from defects in the underlying governance structure** (emphasize is ours) that enable executives to exert considerable influence over their boards."*
So that we suggest that the excessive importance taken by the variable compensation, and hence the grounding principles themselves of the agency theory, are correlated to the ethical crisis, the intrinsic motivation being crowding out by the extrinsic ones. We suggest to look for a more concave compensation curve (Sinclair-Desgagné and Spaeter, 2013).
In their article "The prudent principal", Sinclair-Desgagné and Spaeter argue that the principal traditionally held for being neutral (which we denied in part II to say that they have probably been favourable to high-risk taking in the case of the banks in the pre-crisis period), should better be considered "downside risk adverse" in the future. We shall quote two main reasons they mention: "the investors react asymmetrically to gains and losses" since the works of Markowitz on the portfolio theory; second, they notice that the Corporate Board Members are supposed to act "with fiduciary duties of loyalty and care towards their corporation" and so are supposed to be more cautious in their attitude toward the risks.
So concave incentives (like capped bonuses and claw back rules) could be a good solution in the perspective of "prudent" agent and principal, so that the initial pay-for-performance relation can be changed and can "lean more towards real concavity" (ibid).

- <u>Foster trust between Corporate Governance bodies</u>

Concretely, how can we change the mindset of governance bodies? The issue of trust is about the question to determine whether economics and business belong to others spheres than individual and private sphere when we come to talk about ethics and moral intentions. We do not pretend to solve the debate, but rather to suggest a way to reconcile both spheres.

Williamson (1993) argues that trust in business is calculative, opportunist and rational, and hence it is the object of a contract between the parties involved, who in turn take calculated risks. On the other side, there is the personal trust which is non-calculative, non-strategic and rather irrational (as sociology is, according to him). The lack of trust in the first acceptation would result in a breach of contract, whereas in the second case it would result in a betrayal.
This view implies the existence of controlling and monitoring mechanisms to deter the agents from behaving wrongly and irresponsibly, and help them enter into contracts. Unfortunately, the last crisis demonstrated that these very mechanisms did not function properly.
We pretend that this distinction is cynical and pernicious and helps justify reprehensive conducts and decisions as if business was not conducted by men in full possession of their self-control and conscience. We rather support Freeman (2008) for whom the separation makes no sense: morality is too often perceived as a constraint and social responsibilities as *additional* ones (Wick, 1996). In the separation perspective, human behaviour are the result of radically different motivations than ethical ones: we suggest that extrinsic motivations such as power, social status, money, greed … crowd out intrinsic ethical motivations as discussed in part II. We suggest on the contrary that finding the way to crowd-in intrinsic motivations, both worlds could meet again. In this context, the previous part on virtues and moral sentiments find another argument to be paid special and careful attention to: education to and practice of virtues are of prime importance to reconcile to two worlds; leaders and small worlds have definitively a decisive responsibility in a fiduciary governance environment.

- Enhance soft supervision: do not regulate more, supervise better

Building on the conclusions of the precedent point, we are glad to see how the Group of Thirty, very recently, open the way to such a reconciliation.
We are perfectly conscious that a call for virtue is necessary but not sufficient and that regulation and monitoring rules are a necessary evil.
Nevertheless, we strongly support the recent report of these thirty leaders who call for a change in the way corporate governance organs should function.
*"It is time to create a new paradigm ... **Mutual respect and trust, and surprise-free relations**, are needed not only during times of stress. Rather, long-term investment must be made to maximise relations between supervisors and boards. ... What is needed is not more of the same (regulation and rules- precision added), rather it is **a step change in the level and quality of the interaction** between boards and supervisors. ... Everyone involved must understand the essential role that judgments-based supervision, as opposed to regulation or rule setting, plays in financial stability. ... The goal is effective two-way communication, predictability and no surprise from either party. ..."* (Group of Thirty, 2013, pp. 5, 6, 2).
This influent group statement is very important insofar as the change will come from the elite we underlined above. Moreover, this statement give weight to the three psychological needs analysed previously: they call for more autonomy, relatedness and competence.
To reduce "hard regulation" through an intelligent selection of the strictly necessary reporting and procedures and to give way to a skilful supervision and a qualitative collaboration are the priorities in order to build efficient *and* effective Corporate Governance practice.

5. Conclusion

We have suggested a motivational relationship between the financial and the ethical crisis, beyond the obvious reasons and causes traditionally put forward such as excessive risk-taking culture, economical imbalances and monetary policy reasons.
Two biases coming from early agency theory may have caused the crowding out of agents' intrinsic motivations but also of the principals' ones: the pay-for-performance rule with increasing variable part and bonus, on one hand; the frenetic need to regulate, control,

monitor coming from a mistrusting relationship between principal and agent, coupled with an increasing number of rules and reporting, on the other hand.

We argue in turn that ethics could foster trust, and reciprocally, in a revisited Corporate Governance perspective. To open the debate and suggest a future avenue of research we shall formulate the following question: What if ethical conscience became another Principal to take into account?

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