BACHELOR THESIS

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The potential conflict of interest between bank’s profit maximization and the interest of its clients

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Executive Summary

The presented bachelor thesis scrutinizes the potential conflict of interest which may arise from two conflicting roles of banks. On the one hand, as Eichler et al. (2013) point out in their study, the financial sector (of which banks are a significant part) can be considered as a network sector, because of the catalytic effects it has on all other sectors in the economy by allowing them to function more efficiently and effectively. On the other hand, a major part of the banking institutions are typical profit maximizing companies. Therefore, it is inevitable that in certain situations inappropriate incentives of bank executives and employees would deter them from acting in their clients’ best interest.

The topic conflict of interest in the financial sector has been widely discussed among scholars, especially after the Global financial crisis in 2007. Accordingly, the presented bachelor thesis is based on a comprehensive literature research. The objective is to explain why such a conflict arises in the first place and to then demonstrate it with examples.

In the beginning it is explained why financial institutions, in particular banks, differ from companies in other sectors. Their functions along with their crucial role in the economy are closely examined. In a next step different factors are discussed which are conducive to banks maximizing their profits and are giving them additional incentives to prioritize their own interests and profitability over those of their clients. Among these factors are the present capitalistic economic system, the predominantly private bank ownership, the bank income structure and business model as well as the employees’ remuneration and compensation schemes. Combined with the classic principal-agent problem these factors and circumstances create conditions for banks to act in a profit maximizing manner.

In order to be more precise as to how exactly a conflict of interest may be expressed, the thesis looks in details into churning and tying as two possible manifestations of the arisen conflict. The former is the act of excessive trading by a broker aiming to generate more commissions (Slonim (1986)), while the latter is the case of a bank requiring from a customer who needs a certain banking product, for instance a credit, to purchase additional products or services from the bank or its affiliates as a condition to receiving the desired one (Roberts (1992)).
Further, eventual consequences of the conflict of interest are enumerated. The acts of churning, 
tying and other unethical or even illegal practices enhance some of the risks to which banks are 
exposed – for example compliance risk. They can also result in higher agency costs. Moreover, 
they can entail loss of public trust and loss of confidence in the financial institutions, which, in 
turn, could lead to bank instability.

Then, current and past means of dealing with the conflict of interest are examined. For example, 
one legislative effort in the past was the Glass-Steagall Act which required legal separation of 
commercial and investment bank activities (Cyree (2000)). Nowadays, besides numerous laws 
and regulatory restraints that govern banks’ activities, authorities encourage integrating internal 
risk management processes and practices like “Chinese Wall”. Regarding the compensation 
schemes in the financial services industry, the Institute of International Finance released in 2009 
a report containing Principles of conduct and Best Practice Recommendations. In addition, 
fostering corporate culture which promotes ethical behavior and periodically educating 
employees can also be conducive to preventing an exploitation of the potential conflict of 
interest.

Finally, with all these factors considered, a conclusion that there indeed is a conflict of interest is 
drawn. However, the applied solutions appear to manage it in a proper way, because the two 
concrete expressions which were closely examined in this bachelor thesis – churning and tying, 
did not turn out to be a common practice.