Virtue and Risk Culture in Finance

Dr Anthony Asher
School of Risk and Actuarial Studies
a.asher@unsw.edu.au

Dr Tracy Wilcox
School of Management
t.wilcox@unsw.edu.au

Post GFC –Trading losses, money laundering, LIBOR…

- "I am going to put it very bluntly: I regard the moral environment [in Wall St] as pathological. And I am talking about the human interactions . . . I've not seen anything like this, not felt it so palpably…

  They have no responsibility to pay taxes; they have no responsibility to their clients; they have no responsibility to people, to counterparties in transactions…They are tough, greedy, aggressive and feel absolutely out of control in a quite literal sense, and they have gamed the system to a remarkable extent."

  Jeffrey Sachs, 2013

- " There have been ongoing occurrences of serious professional misbehavior, ethical lapses and compliance failures at financial institutions…. The pattern of bad behavior did not end with the financial crisis...

  I reject the narrative that the current state of affairs is simply the result of the actions of isolated rogue traders or a few bad actors within these firms…

  Ethical problems in organizations originate not with 'a few bad apples' but with the 'barrel makers'. That is, the problems originate from the culture of the firms, and this culture is largely shaped by the firms' leadership. This means that the solution needs to originate from within the firms, from their leaders."

  William Dudley, 2014

Conceptualised as a cultural problem

- “Toxic” cultures in finance → calls for explicit consideration of ethical dimensions of finance cultures *(e.g. Llewellyn et al 2014)*
- “risk management controls were seen as tripwires to be negotiated rather than presenting any genuine constraint on risk taking behaviour” *(National Australia Bank)*
- “culture of perilously high risk lending” tied to a strategy of “aggressive, asset-led growth”, and leadership culture that was “‘brash’, underpinned by a belief that the growing market share was due to a special set of skills which HBOS possessed and which its competitors lacked” *(HBOS)*
- “ignored warnings and fail[ure] to question, understand, and manage evolving risks within a system essential to the well-being of the American public….a big miss, not a stumble.” *(US Financial Crisis Inquiry Commission)*

What are cultures?

- These cultures shape, and are shaped by, actions of individuals.
- Includes ‘sense-making practices’ – the ways in which people make sense of and respond to events and contexts.
  Sense making is influenced by the taken-for-granted assumptions and interpretive schemes (or mental models) that predominate in a particular business context *(e.g. Weick, 1995; Di Maggio 1997)*
- Organisational practices reflect widely-shared sets of norms, values and logics (organising principles that are consciously or unconsciously drawn on)
- Dominant logics and sense-making practices in the finance sector have their roots in neoclassical economics;
- “rudimentary assumptions” of self-interest and profit maximization are, “not only taken as explanatory variables, but also as normative demands indicating how economic actors should behave” (Enderle, 2000)

Cultures are significantly shaped by leadership …

- Blind faith in a leadership that was ill-equipped for the task; insufficient ability and independence of mind on the part of the board and senior management to see what had to be done and what had to be stopped or avoided; unpleasant information hidden, filtered or sanitised; and a lack of sceptical questioning and analysis *(Owen - HIH)*
- “Some CEOs were overly dominant, which the Board as a whole failed to control. Chairmen proved weak; often they were too close to, and became cheerleaders for, the CEO… [and] insufficient scrutiny of, or challenge to, the executive. *(Parliamentary Commission on Banking Standards, 2013)*
- “introspection, lack of insight or sufficient self-criticism, rejection of external criticism.. fear…complacency... [and] … recurring themes of missed warning signals, failure to share information” *(Power et al, 2014)*

→ hubris and narcissism, e.g. HBOS

Risk cultures and technical risk society

- Risk culture seen as central element of governance systems, as important as regulatory structures or external institutions (FSB, 2013).
- > 7x increase in the use of term “risk culture” by British finance industry professional bodies & consultants (2007 – 2011)
- Neoliberal economic worldview shapes conceptualisations of risk → “entrepreneurial, risk taking normativity” (rather than risk in terms of adverse consequences)
- Narrow economic worldviews plus ‘technical -scientific’ approaches and the “calculus” of risk → “a type of ‘technological moralization’ that no longer needs to employ moral and ethical imperatives directly” (Beck and Holzer, 2007, 5-6)

Risk system as complex system

- Positive & negative feedback loops, effects distant in time and place
- "Connective structure" (Foster, 2005) of the complex risk system and the broader systems of financialized capitalism → 'ripple effects' of actions on Wall St and the City of London extended across Europe and into developing economies
- Connectivities can be
  - <u>Social</u> - between system participants e.g. hedge funds, investment banks, clients, shareholders)
  - <u>Technological</u> – use common 'technologies' e.g. derivatives, CDOs (Holzer & Millo, 2005)
- "Second order dangers" created by risk management practices themselves (Holzer & Millo 2005)
- Conventional economic worldviews, premised on atomized individual behaviour will always fall short

Conventional approaches

- Rules-based and ‘external’
- Premised on a mechanistic and reductionist approach to the finance system (voluminous documentation, prescriptive, complex & elaborate models, separate functional areas for risk)
- “if Strategy and Culture are fully aligned then Actual and Correct Risk Treatment will match” *(consultants)*
- Reliance on ‘fixing the component parts’ and ‘pulling control levers’; little consideration of relationships, feedback loops and underlying causes; techno-scientific quantification of the essentially unknowable future
- In essence, regulators are using the “same tools…that market participants use to control their risks” *(Holzer & Millo)*

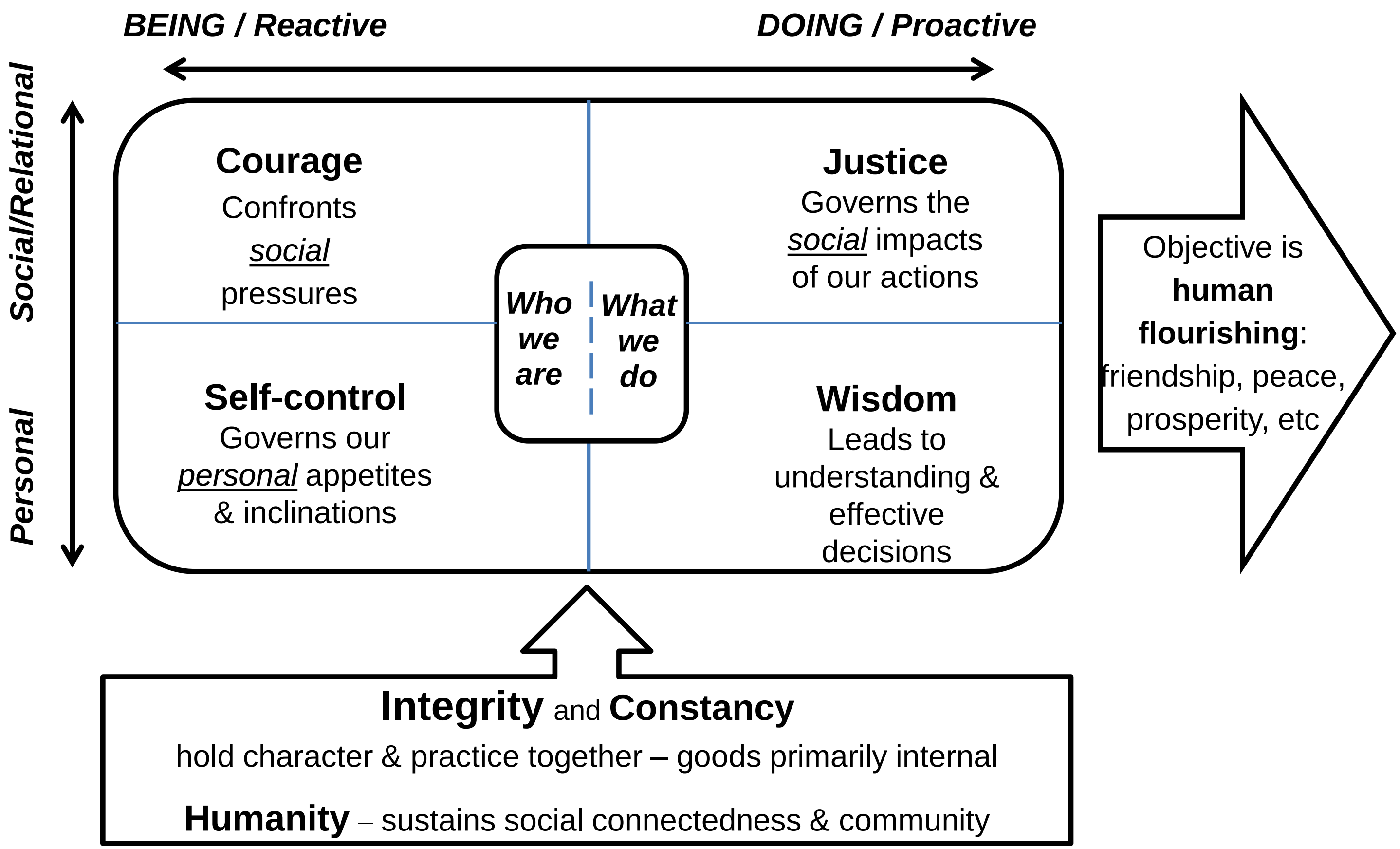
Risk management is a normative exercise

- We know risk cultures and leadership cultures have been dysfunctional
- Normative approach of virtue ethics provides a means of pinpointing what ‘functional’ might look like.
- Virtue ethics is a non-reductionist approach which instead compels one to consider organizatgional integrity in achieving overall purpose or *telos* of human flourishing − individually and collectively
- Follow on from Macintyre (1983) and Moore (2012), here we going back to a classical conceptualisation of the virtues
- Personal characteristics and <u>practice </u>with purpose

Virtues are universally understood and valued

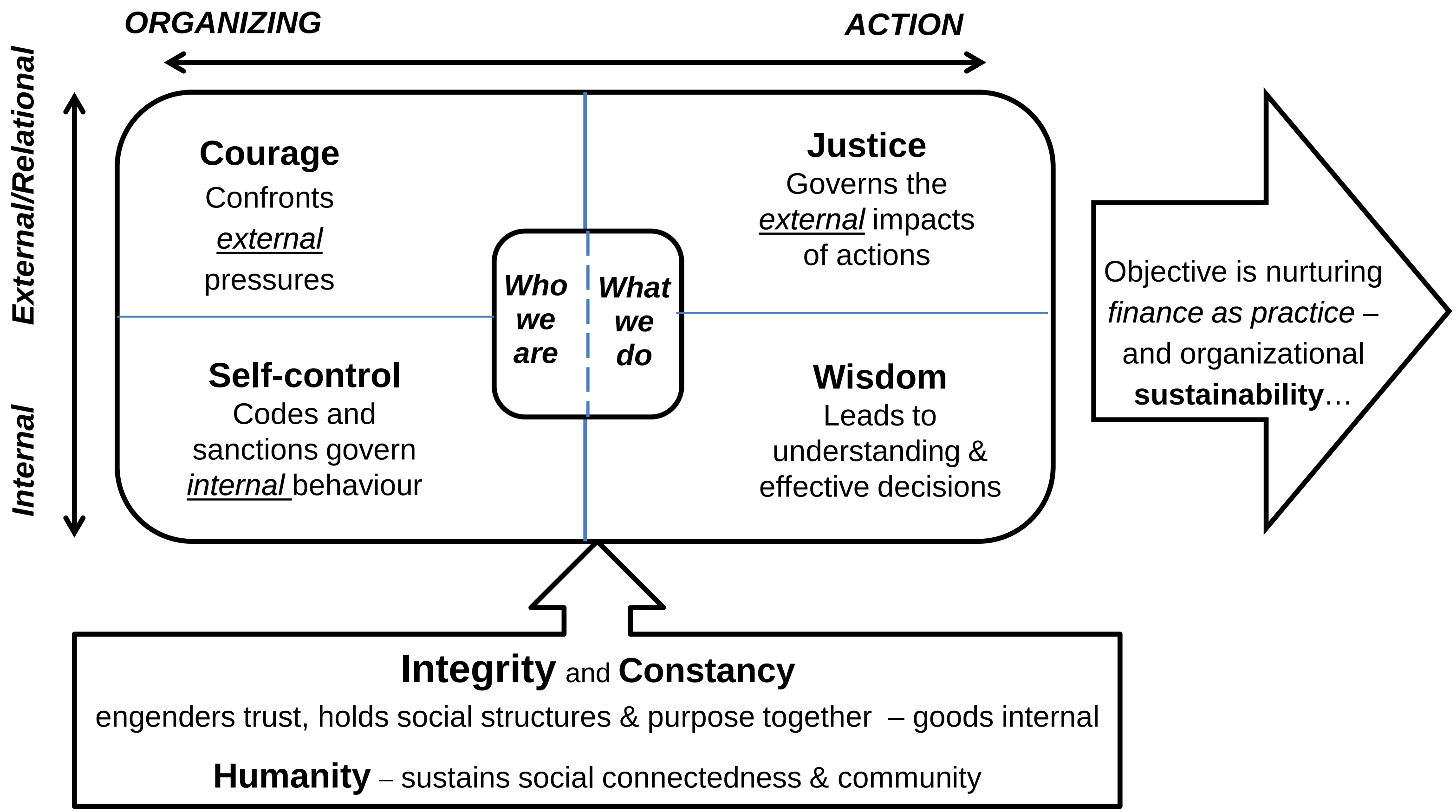
- Idea of virtuous ‘character strengths’ supported by positive psychology – empirical research
- Individually e.g. McGrath study of >1 million respondents
- Organizationally e.g. Cameron and colleagues.

A Model for Personal Virtues in Finance – restoring Finance as practice



Adapted from Asher 2015

A Model for Organisational Virtues in Finance



Adapted from Asher 2015

Classifying the dysfunctional

Elements of dysfunctional risk culture (Power et al 2013, pp. 13-14)	Corresponding virtues
Deviant subcultures	Self-control
Over-confident corporate risk-taking	Justice – failure to avoid harm
Brash' and aggressive 'tones from the top'	Wisdom; Self-control
Breaches routinely disregarded	Integrity
Introspection, lack of insight or sufficient self-criticism, rejection of external criticism	Wisdom; Self-control
Fear	Self-control, Integrity Courage
Complacency... recurring themes of missed warning signals, failure to share information.	Integrity and constancy

Classifying required actions

Recommendation	Corresponding Virtues
Refocus on purpose (& common good) *(Moore 2012, Llewellyn et al. 2014)*	*Telos* – human flourishing; *Finance as practice*
Refocus on customers and their needs *(Llewellyn et al. 2014; Power et al 2013)*	Justice, Humanity
Select for, and nurture, pro-social behaviour *(Moore 2012)*	Justice, Humanity
Build intrinsic motivation into job design *(Moore 2012)*	*Finance as practice*; Self-control
Remuneration practices/ incentives *(Dudley 2014, Moore 2012, UK Parlt Comm 2013, FSB 2013)*	Self-control Justice
Participatory decision-making processes, self-governance, and critical questioning (*Moore 2012, Dudley 2014, FSB 2013)*	Wisdom, Courage; Integrity and Constancy
Cultivate trust in employees, trustworthiness in managers *(Moore 2012), Power et al 2013*	Justice Integrity & Constancy
Encourage positive group identity *(Moore 2012)*	Integrity & Constancy Humanity
Accountability for progress in reshaping culture *(Dudley 2014, FSB 2013)*	Self-control (Org) Justice, Wisdom

Developing the virtues

- Responsibility of the board
  - Hubris and board/CEO renewal
  - ‘Fit and proper’
- Relational spaces which enable “reflective critical questioning of standards hitherto taken for granted” (MacIntyre, 1999b, p. 317; Wilcox, 2012)
- Corporate break-up of the truly toxic
- Salience – professional and ethical standards & codes
- Education beyond the reductionist
- Personal agency and courage

Banking and Finance Oath - Australia

"Trust is the foundation of my profession.

- I will serve all interests in good faith.
- I will compete with honour.
- I will pursue my ends with ethical restraint.
- I will create a sustainable future.
- I will help create a more just society.
- I will speak out against wrongdoing and support others who do the same.
- I will accept responsibility for my actions.

In these and all other matters;

My word is my bond."

Source: http://www.thebfo.org/The-Oath

Proposed British Banking Oath

- “I swear to fulfil, to the best of my ability and judgement, this covenant:
- I will do my utmost to behave in a manner that prioritises the needs of customers. It my first duty to provide an exemplary quality of service to my customers and to exhibit a duty of care above and beyond what is required by law.
- I will apply myself to ensuring that the work that I perform is in line with values that engender the responsible creation of value. It is my duty to conduct my business in an ethical manner and to ensure that my actions impact positively on the wellbeing of people both inside and outside my enterprise.
- I will confront profligacy and impropriety wherever I encounter it, for the conduct of bankers can have dramatic consequence for society.
- I will remember that I remain a member of society, with special obligations to the financial security and wellbeing of my customers, their families and the communities they reside in.
- If I do not violate this oath, may I benefit from the prosperity that comes from serving customers well.
- May I always act so as to preserve the finest traditions of my calling and may I long experience the joy that comes from supporting the needs of society.
- This oath I make freely, and upon my honour.”
    - *Source: Llewellyn et. al, 2014*

Bankers' Oath - Netherlands

"I swear/promise within the limits of my role that I perform at any moment in the banking sector:

- that I will perform my duties with integrity and care;
- that I will carefully consider all the interests involved in company, i.e. those of the clients, the shareholders, the employees and the society in which the company operates;
- that in this consideration, I will give paramount importance to the client's interests;
- that I will comply with the laws, regulations and codes of conduct applicable to me;
- that I will observe confidentiality in respect of matters entrusted to me;
- that I will not abuse my knowledge;
- that I will act in an open and assessable manner and I know my responsibility towards society;
- that I will endeavour to maintain and promote confidence in the financial sector.

So help me God/This I declare and promise."

Source: NVB, 2014

Research challenges

- Data needs to be collected
- Measuring the virtues?
  - Qualitative research, virtues and professional identity
  - Self–reported, Regulators, Analysts
  - Board tenure (non-linear)
- Measuring risk?
  - Profit volatility
  - Return on capital (again non-linear)
  - Staff engagement, turnover / Promoter scores