Virtue, hubris and risk culture

Prepared by Anthony Asher, Victoria Clout and Tracy Wilcox

Presented to the Actuaries Institute
Financial Services Forum
5 – 6 May 2014
Sydney

This paper has been prepared for the Actuaries Institute 2014 Financial Services Forum. The Institute’s Council wishes it to be understood that opinions put forward herein are not necessarily those of the Institute and the Council is not responsible for those opinions.

The Institute will ensure that all reproductions of the paper acknowledge the author(s) and include the above copyright statement.
Abstract

This paper suggests that devastating, but avoidable, organizational failures are often not so much a consequence of business risks but of an absence of business virtues in leadership. The current focus on the importance of risk culture in good risk management practices seems to recognise this, but we suggest that the approaches to culture are often inadequate in three important, and interrelated, respects. Firstly, they tend to fall back into a reductionist and mechanistic treatment of governance, without adequate appreciation of the firm as a “complex adaptive system” needing to be addressed holistically. Secondly it continues to attempt to model the future “scientifically”, when it is unknowable in material respects. Finally, its ethical model is that it is possible to define good behaviour, rather than recognising that it is character and the basic virtues that require development.

Key words: Risk management, virtue, integrity, narcissistic organizations, compliance

Introduction

Since the global financial crisis there has been a widespread sense of a ‘crisis of governance’, and a failure of risk management. To some extent this is consequence of loss experience that is inevitable in an imperfect world, but we share the feeling that regulation and governance are partly on the wrong track.

That risk should be managed is a normative statement. Companies have legal and moral obligations to creditors, policyholders and depositors that cannot be met if the companies act recklessly. Boards and managers have to manage these and other legal and moral obligations to shareholders and staff. Disregard for these contractual obligations and reasonable expectations is dishonest in that it misleads stakeholders.

As Krystis (2012, 46) puts it:

“All scandals refer to misrepresentation and concealment … Something is hidden, or repressed from consciousness, and when it is revealed, for whatever reasons, a mechanism of blame sets off. The blame structure and the distribution of liabilities point to the ethical potentials …”

There is not just the concealment, but the consequences of poor risk management are losses by innocent third parties. Failure to take all reasonable steps to meet legal and moral obligations is a failure of integrity, justice or perhaps diligence. Failure to recognise and respond adequately to risks displays a lack of prudence, stemming often from overconfidence – the ancient term being hubris, which suggests a proud wilfulness rather than mere ignorance.

In what follows, we discuss the central role of risk culture in the prudential management of businesses that are complex adaptive systems. We suggest that it is an error to attempt to address the question mechanistically, and that this error is
Virtue, hubris and risk culture

evident in the current approach to executive remuneration, regulatory wording and financial modelling.

A more fruitful approach is to recognise the complexity and the “contingencies” especially in the motivation and behaviour of people. We suggest that virtue theory provides the most promising approach to nudging attitudes, behaviour and risk culture to recognise fully the legal and moral obligations of financial organizations.

Finally, we make some suggestions as to the role of regulators and boards in developing the virtues of integrity and prudence in organizations.

Risk culture

We see risk culture as a central element of governance systems, as important as regulatory structures or external institutions. By ‘risk culture’, we mean the routines, norms, behaviours and worldviews (interpretive schemes) that relate to risk taking and its mitigation (cf. Ashby et al, 2013). We base our view on the definition of governance proposed by Sapelli (2013, p87):

“the set of instruments and institutions and therefore of cultures that are suited to strike a balance of powers so that none of the actors may prevail on the other and prevail especially in the sense that its opportunist interests may become the prevalent interests in the firm.”

Much of what is written about risk culture suggests that there are a variety of alternatives that can be chosen by the board and imposed on the organization. Debates about what risk cultures are, and should be, have become increasingly prevalent, with a more than seven-fold increase in the use of the term by British finance industry professional bodies and consultants between 2007 and 2011 (Power et al 2013).

In this paper we argue that while this topic has garnered much regulatory and scholarly interest over the past two decades, many of the ‘solutions’ offered have been based on flawed assumptions. As representative of the best of this, we refer to the Financial Stability Board (2013). This consultative document on risk culture has been issued by the FSB, as the peak international body appointed by the G20 in this area. To the FSB and many others, good risk management consists of well documented and clearly articulated risk strategies and responsibilities, with deep understanding of measurable risk. In financial organizations, regulators have encouraged if not required voluminous documentation, separate functional areas for risk and elaborate models. The FSB’s earlier publications, for instance, focus on “financial institutions’ risk governance and internal controls, risk management functions, as well as risk aggregation and risk reporting capabilities” – and remuneration practices.

We were delighted to find the response of the International Actuarial Association (2014) (IAA) to the FSB consultation paper, and agree: “that understanding the risk culture of a financial services firm is substantially more complex than what is
presented in this paper.” Certainly in Australia, the two best known recent failures – those at HIH and NAB – have been ascribed in significant measure to poor culture (Owen, 2003 and Thomson and Jain, 2011). In NAB’s case, it was a culture where traders felt “invincible”, and far removed from their legal and ethical responsibilities. As Justice Chettle acknowledged when sentencing two of the rogue traders at the centre of the NAB scandal, “I accept that your offending occurred in a culture of profit-driven morality” (The Age, 2006)

Researchers in the field of business ethics have long been interested in questions of how and why individuals in organizations come to do the wrong thing. Part of the problem lies in the ways in which responsibility for harm to others becomes diffused or fragmented. The harm that can be caused as a result of the actions and decisions of a board or senior executive team is often far more abstract than the tangible and competing demands for profits or outputs (Darley, 2005). So it is not merely information that is fragmented (‘no-one told me!’), but any sense of duty or responsibility for harm caused. Additionally, socialization of new members (of boards of directors, executive teams, trading teams) into sets of values that place ‘winning at all costs’, ‘fleecing the customer’ or ‘covering up’ at the centre of a firm’s culture (Darley, 2005). In the case of NAB, for example, young traders were socialized into a culture where “risk management controls were seen as tripwires to be negotiated rather than presenting any genuine constraint on risk taking behaviour”, according to APRA investigator David Lewis (cited in Fagg, 2005).

Complex adaptive systems

Since the early 1980s, the field of organizational behaviour has produced an extensive body of literature on the topic of organizational culture (Di Maggio, 1997; Schein, 1996, 2010). From this research we can take away an understanding that cultures are embodied in both material and symbolic practices: formal routines and standards; informal behavioural norms and expectations; as well as the interpretive schemes through which people make sense of the world. Multiple cultures and subcultures can exist in organizations, as can distinct professional cultures and norms. Perhaps most importantly, organizational cultures and the actions of organizational members are recursively related, in other words, cultures shape and are shaped by what people do. From this perspective we can see that the approaches to risk within and amongst organizations are facets of broader, dynamic sets of cultural factors.

In their recently released study of risk cultures in the British financial services industry, Power, Ashby and Palermo (2013) found that while the concept of risk culture was ‘rather fuzzy’ (p2), one of the most important operational issues was how the control-risk trade-off (often expressed in terms of risk appetite) played out in practice. The risk system is complex and dynamic, and comprises an array of institutions and actors, each with their own interests and role to play. Regulators, insurers, boards, senior executives, operational employees and the public are all part of this system.

What we know about complex systems is that whether local or global, they can challenge and confound leaders interested in bringing about lasting and positive
change. Author Robert Pirsig (1999 p102) draws our attention to the power and resilience of social systems when he observes:

“If a factory is torn down but the rationality which produced it is left standing, then that rationality will simply produce another factory. If a revolution destroys a government, but the systematic patterns of thought that produced that government are left intact, then those patterns will repeat themselves in the succeeding government. There’s so much talk about the system. And so little understanding.”

This is because changes in one part of the system can have non-linear effects and impacts elsewhere in the system that are difficult to predict. It is for these reasons that leaders may fail to ‘see’ the existence of an ethical issue in the first place. Sense-making practices, which are influenced by the logics and mental models that predominate in a particular business context, can render moral dilemmas ‘invisible’ to leaders (Werhane 2008). As Senge has put it:

“Business & other human endeavours are also systems. They, too are bound by invisible fabrics of interrelated actions, which often take years to fully play out their effects on each other. Since we are part of that lacework ourselves, it’s doubly hard to see the whole pattern of change. Instead we tend to focus on isolated parts of the system, and wonder why our deepest problems never seem to get solved. (cited Waddock, 2006)”

Management requires knowledge of people particularly, judgement in its widest sense, and an acute sense of observation to identify stresses and early signs of change. Given the complexity of the risk system, it is perhaps not surprising that we look for ways to simplify this elaborate and messy reality, often drawing on taken-for-granted mental models and frameworks to do this. But if the view of the risk system is too blinkered, we fall prey to reductionist thinking, the antithesis of systems thinking.

In this sense, assumptions that risk cultures can be simply ‘designed’ or engineered betray the mechanistic world view of many approaches to this issue, as well as a degree of hubris on the part of those claiming to have the ‘right’ set of tools to carry out such ‘engineering’. We see this problem in consultant advice along the lines of “if Strategy and Culture are fully aligned then Actual and Correct Risk Treatment will match” (Dawson and McDonald, 2011). Statements such as this not only reify1 the complexity and messiness of organizational strategies and culture (note the proper noun status in the above quote) but also assume an unproblematic notion of ‘fit’ between strategy and organizational practices. As we have argued, though, risk systems simply cannot be managed mechanistically.

---

1 Meaning that an abstract idea is spoken or written about as something entire concrete
Dominant personalities

The question then arises as to how change can be effected? It is widely recognised that it starts at the top. Justice Owen (2003) expresses the relationship clearly in the HI Royal Commission report (p xvii):

“A cause for serious concern arises from the group’s corporate culture. By ‘corporate culture’ I mean the charisma or personality—sometimes overt but often unstated—that guides the decision-making process at all levels of an organisation. In the case of HIH, the culture that developed was inimical to sound management practices. It resulted in decision making that fell well short of the required standards.

The problematic aspects of the corporate culture of HIH—which led directly to the poor decision making—can be summarised succinctly. There was blind faith in a leadership that was ill-equipped for the task. There was insufficient ability and independence of mind in and associated with the organisation to see what had to be done and what had to be stopped or avoided. Risks were not properly identified and managed. Unpleasant information was hidden, filtered or sanitised. And there was a lack of sceptical questioning and analysis when and where it mattered.”

He goes on to identify the problem of “dominant personalities”, in particular the CEO, Ray Williams. The risk systems were more than adequate but management was not prepared to listen. The same problem was identified as a major issue in the Equitable failure in the UK, with Justice Penrose describing the finding the Actuary and Chief Executive “an idiosyncratic and autocratic individual … without significant control by his colleagues, his board or the regulator.” (p 741)

Joint positions, such as Roy Ranson’s at the Equitable, and joint chief executive and board chair are recognised as a source of risk. This is aggravated when they have little industry knowledge and are expected to work short term wonders on the financial fortunes of the firm – as the likelihood of unintended consequences increases. Dominant players flourish in what have been identified as narcissistic organizations (see Grant and McPhee, 2103). American mega-CEO ‘Chainsaw Al’ Dunlap provides another case in point (Byrne 1999).

In his classic study, Janis (1971) suggested that one of the consequences of a highly cohesive group (or a group where dissent is not tolerated by its leader), was the emergence of groupthink, where group members lose their capacity to critically evaluate decisions or actions. One can easily imagine situations where a combination of dominant individuals and groupthink processes means that a Board loses its ability to raise questions about ambitious plans, and to take adequate precautions against failure.
On this subject, FSB (2013) rather weakly suggests better succession planning. This does not meet with the IAA’s approval:

“The only thing that can offset a strong personality is another strong personality. And in fact, the presence of multiple strong personalities can be an indicator of a robust risk culture. The strong personalities will, for example, promote a healthy challenge process.”

This is however only partly true. Multiplying hubris or narcissism is unlikely to increase sober judgement. Responding appropriately to powerful personalities requires courage, and we are at least partly persuaded by Chesterton:

“The strong cannot be brave. Only the weak can be brave; and yet again, in practice, only those who can be brave can be trusted, in time of doubt, to be strong.”

Excessively powerful personalities should preferably not be allowed to occupy powerful positions where they can dominate. There is much that could be said on this topic, but we like Gini and Green:

“Leadership is not just a set of learned skills, a series of outcomes, a career, a profession, or a title. Leadership, at its core, is about character: specifically, a character attuned to its ethical responsibilities to others. The kind of character that, in regard to others, always tries to do the right thing, for the right reason, on purpose.”

Chapple et al (2013) results suggest that firms that were subject to shareholder litigation in the form of a securities class action displayed weaker corporate governance than the matched non-litigated firms. The study contributed to the understanding about firms subject to securities litigation and provides evidence that the presence of a nomination committee may be associated with higher agency costs. In addition, the influence of CEO duality may reduce the effectiveness of a firm’s nomination committee. This is consistent with other prior research into the influence of the CEO (Hermalin and Weisbach, 1988; Monks and Minow, 2004; Ruigrok et al. 2006; Westphal and Zajac, 1995).

**Management remuneration**

The simplistic and mechanistic view of governance is nowhere more evident than in management remuneration. We would also suggest that excessive remuneration has fed the rise of dominant personalities – paid so much more than their colleagues, who are thus increasingly unable to question them.

The current executive remuneration system seems at least partly founded on deceit or wilful ignorance. The evidence is this:

- Until very recently, most bonuses were dependent on share options, the main value driver of which was a rising stock market. No one with any
understanding of business or the markets could have made a genuine argument that this rewarded performance.

- There is widespread evidence (reported below) that the prevalence of share options has been accompanied by increasing levels of earnings manipulation to deceive shareholders – undermining the notion that options aligned the interests of management and shareholders.

Perhaps less obvious, we would argue that the systems that make up the firm are far too complex to suggest that it is possible to evaluate – even approximately - the impact of any one individual on “performance”. We are therefore disappointed that FSB (2009) is still able to suggest that: “a substantial proportion of compensation should be variable and paid on the basis of individual, business-unit and firm-wide measures that adequately measure performance.” This seems equivalent to assuming that all dangerous driving will result in an accident and it is sufficient to punish those who actually crash. Risky behaviour has to be addressed before it does damage. It is widely believed that the longer the period since the previous disaster, the more likely the hubris and complacency, which can only be fed by rewarding risk taking.

We shall later return to the subject of punishment and how that too is normally inappropriate.

Much remuneration of executives has been structured with the aim of attempting to align the incentives of the ‘agent’, i.e. executives, with those of the principals – i.e. shareholders (Jensen and Meckling, 1976). Heath (2010; 137) points out that agency and game theory assumes that people will always “defect” if it is in their short term material interests. He says:

“No matter how strenuously agency theorists may insist that theirs is only a positive theory of the firm, and thus entails no value judgments, the fact is that the basic approach has as its foundation a normative theory of practical rationality, one that categorizes certain forms of action as rational and certain other forms as irrational. The fact that moral rules (or cooperation) get consistently categorized within such models as irrational, and opportunism (or defection) as rational, might easily lead more impressionable minds to the conclusion that they should learn to ignore moral constraints …”

He goes on to give evidence that this is true of economic graduates and ends up describing the modern firm:

“Thus, it would be no surprise to discover that a social environment in which the dominant assumption is that “it’s every man for himself” is one that would not only encourage unethical behavior, but could become positively criminogenic.”
Earnings management

A particularly excoriating impact of aligning managerial remuneration using options has been a rise in earnings manipulation. It is a particular problem faced by actuaries and accountants in their professional capacity.

In reporting the results of their survey of CFOs, Dichev et al (2013), report that

“CFOs feel that most earnings misrepresentation occurs in an attempt to influence stock price, because of outside and inside pressure to hit earnings benchmarks, and to avoid adverse compensation and career consequences for senior executives.”

If the CEO and CFO are manipulating accounts and deceiving shareholders, then this undermines the integrity of the entire organization and – we suggest – would be a major indicator of higher risk.

Manipulation appears to have been, until recently at least, practiced by most firms as reported by Brooks (2010) – who looks at studies from before Sarbenes-Oxley in 2002. Dichev et al (2013) survey finds that the CFOs believe that 20% of companies in the USA are still manipulating accounts.

Clout et al. (2013) examines the association between earnings quality and corporate governance mechanisms in Australia, pre- and post-CLERP 9 auditor independence regulations being introduced. The study suggests that a greater board independence and board financial skill are associated with higher earnings quality. On the other hand, higher concentrations of insider ownership were associated with lower earnings quality. This suggests an important role for governance and ownership structure for the culture of the firm as manifested in the earnings quality.

The problems of prescription

Related to the mechanistic view of the firm and its associated risk is the explosion of documentation and prescription. Conventional approaches to the ‘problem’ of risk cultures have involved increased regulation in many jurisdictions. Whilst regulation is acknowledged as a necessary component in any risk system, problems arise when regulation is over-elaborate. Regulation has in fact largely missed the point by focusing too much on detail rather than capability. One might argue that boards and managers who cannot generate their own rules are not fit to practice. Prescription infantilizes them, removing their responsibility and agency.

APRA’s Common Prudential Standard CPS 220, and its implementation as reflected in annual reports, provides an example. The standard and the declaration are focused on compliance: there needs to be well documented systems in place to manage risk. The systems are however a means to an end. The real question is whether the regulated entities are actually managing the risk. Looking at how they inform shareholders is one test. CBA’s 2013 annual report is an exercise in puffery,
telling its shareholders that it has the systems in place but failing to discuss any risks – mentioning some only in passing. NAB’s 2013 annual report has a long and relatively comprehensive list of risks, which we imagine is typical of the approach used for APRA reporting. It fails however to focus on the more important risks. Some of these are obvious: high household debt and elevated house prices funded in significant measure by foreign liabilities debt. (International Monetary Fund, 2012). Others are less obvious, but we would suggest that more public attention might be given to risks inherent in money laundering. The last evaluation of the banks by Financial Action Task Force (2005) found Australia entirely non-compliant in nine of 49 recommendations – including “Customer due diligence”. The Australian banks have raised hundreds of billions offshore in the past two decades, from wholesale markets where many of the larger banks have been found to be laundering money. There is another review this year, and it will be interesting to see whether much has changed. Our understanding is that it has not.

Regulators sometimes attempt to rise above prescription and limit themselves to “principles” as FSB (2008):

“The FSB Principles are high level to allow financial institutions to develop an effective RAF (risk appetite framework) that is firm-specific and reflects its business model and organisation.”

In practice, however, the regulators require volumes of documentation – as they slip back into mechanistic thinking – requiring, in this instance, management to “identify, measure, monitor and report on the risk profile relative to established risk limits on a day to day basis.”

In philosophy, the view that good behaviour can be prescribed (or bad behaviour proscribed) is referred to as “deontological”. Its failure is perhaps best illustrated by the story of Kausika, from the Hindu Mahabharat, who “ignorant of the subtleties of morality, fell into a grievous hell” by vowing to tell the truth. He thereby betrays the whereabouts of refugees fleeing from robbers who kill them. There are inevitably situations that are not covered by rules.

In economic theory, the standard explanation for the existence of firms (rather than networks of independent contractors) derives from Coase (1937). The cost of formal contracting between managers and employees is too expensive – not least because the duties are continually changing. Regulators’ attempts to formalise these contracts are therefore expensive and counterproductive if they lead to delays in implementation. Managers need a wide scope to interpret “risk appetite frameworks” that formal board policies inhibit. Staff knows this and this brings the entire risk management framework into disrepute.

It is the spirit and not the letter that is important. What are required are managers and staff who are committed to the spirit – to a culture – of integrity.
Virtue, hubris and risk culture

Over-complex financial modelling

The mechanistic view of the firm is often accompanied by a mechanistic view of the future. The future must be modelled if we can to make sensible decisions about product design, pricing and capital. When experiences differs from expectation, it should be reported in an actuarial type control cycle. Regulator-prescribed models suffer from the problem of all prescription: inflexibility and disempowerment.

There are two specific arguments against overelaborate risk models. The first is made persuasively in Haldane and Madouros (2012): the complex models do not work as well. Basle I rules would have worked better than Basle II in the 2008 financial crash.

The second is that the results are often not material. The obvious example is operational risk. In spite of the huge effort applied to operational risk capital, Basle (2006) notes that in respect of actually doing something to relate this to their “business environment and internal control factors”, “the practice for many banks is still very much in its formative stages”. Given that the sum impact of the modeling has been to increase capital by some 10% (which falls below some measures of materiality), it must be asked whether the effort is of any value. The same can be said of the operational capital reserves of 0.25% recently introduced by APRA for superannuation funds. Asher and Duncanson (2008) argue that 0.25% is well below the level of materiality for investors in managed funds – in superannuation or not.

Models are at best illustrative; what are needed are managers and staff who are committed to develop an expert understanding of the underlying forces, and of responding appropriately.

Virtue theory and character

Virtue ethics provides us with a means of cutting through this need to address the complexities of context, cultures and situations by writing detailed rules. The idea that individuals possess virtues that come to define their character comes from ancient philosophers such as Aristotle and Confucius. Virtues are habits of being, acquired through practice, and as such they apply to everyone. They are aspirations that (almost) everyone who has thought about them, would want to achieve: honesty, courage, self-control etc. In a recent speech, for example, the Archbishop of Canterbury, appealed to British bankers to be “essentially good”, where “goodness is the result of serving our highest interest, not of limiting our obligations” (Welby, 2013, see also Power et al 2013). Welby is essentially appealing to bankers and others in the financial services industry to cultivate the kind of virtues that would engender positive cultures where hubris, narcissism and groupthink are left behind.

Various philosophers have compiled lists of virtues seen as necessary for ‘the good life’, including the virtues of courage, honesty, prudence, fidelity, justice and compassion (see, for example, Comte-Sponville, 2001). Solomon (2003) reminds us of the normative nature of virtues, adding that “they are not mere behavioural tendencies” (p48). Virtues transcend ‘personality’, and they also transcend the
assumption that the context (or system) determines the action choices available to an individual (Wilcox 2012).

Scottish philosopher Alasdair MacIntyre (1999) has argued that the virtues of integrity and constancy underpin the possession of any of these other virtues, and are particularly important in business contexts, where decoupling of responsibilities can prevail. By integrity, he means remaining true to oneself and one’s moral character in spite of pressures to ‘be something else’ in different contexts, rather than compartmentalising that part of oneself that is, say, a business executive from that part that is a parent. Constancy implies that one remains true to their character over extended periods of time, so that moral character doesn’t, presumably, ‘wear out’. If board members possessed these qualities individually and encouraged the development of these virtues through cultural norms and practices, we would see the type of reflection and critical questioning that could overturn pressures for short-term profit taking, cost-cutting, or stratospheric executive remuneration. It would be possible then to break any ‘vicious circle’ and replace it with a virtuous one. As Warren Haynes, guitarist with the rock band the Allman Brothers once put it, “It’s not so important to play so many notes, as to mean the ones that you do play.” (Cited Freeman 2002)

Risk culture fails when inappropriate informal behavioural norms and expectations override if not the letter of the formal standards, then certainly their spirit. One might argue that it persists because of from a failure of sufficient participants to display the integrity, wisdom and courage that are the traditional virtues and which make up the virtuous character.

**Error tolerance and restorative justice**

One of the perverse results of a mechanistic approach to management is the idea of “zero tolerance” for mistakes. Human error or mistakes and unfavourable outcomes from business risks are often difficult to distinguish – and often require the same type of response. Neither can be entirely avoided, both should be acknowledged and taken seriously.

A good risk culture must go beyond awareness to being quick to acknowledge and correct errors. It needs to admit to being prone to making mistakes, quick to admit them when they are wrong, and quick to correct and often to forgive them. Many huge losses can be blamed on failure to ensure that there are sufficient checks and balances – because people do not admit they are prone to failure. This is more obvious in health and safety matters: protective clothing and safety mechanisms being unused. In finance, it is back offices disempowered and auditors belittled.

Mistakes and failures will occur. In order to be addressed and addressed quickly, the perpetrators must have no need or incentive to protect themselves or hush up the error. In many organizations, those who admit to mistakes are routinely punished for them, in some way. Too often, the boss’s response to being told of an error is: “bring me a body”.

12
John Braithwaite (2002) makes some critical points in this context. Braithwaite and Drahos (2002) talk about the lessons learnt from the Three Mile Island nuclear disaster, which have led to a 90% reduction in automatic shutdowns:

“The most important one is that you do not want operators to be rule-following automatons as a result of a tough regime of regulatory enforcement. You want them to be thinking systemically as team players about problem prevention, not about protecting their backside against a prosecution.”

Braithwaite advocates a responsive regulation involves a variety of strategies. It builds on those moral standards that are demonstrated by meaningful internal codes of ethics and industry standards. These provide the basis not for punishment, but for “re-integrative shaming”, where peer pressure is positively brought to bear on excessive risk takers and those that make mistakes. It can be contrasted with “stigmatising shaming”, which drives offenders into a counter-culture of passive resistance and mechanistic compliance. There is an illustration in our appendix how restorative justice might have worked if it had been applied at Arthur Andersen in the nineties.

Application

An acknowledgement of the complexity of the risk management system, and the multiple causal mechanisms driving the ways in which risk is ‘seen’ and managed in organizations leads us to look for alternative ways of dealing with the issue of risk management and risk cultures. Recent interventions at the Board level have offered some promise in terms of providing an entry point for enabling changes to a firm’s risk practices and the cultures underpinning them. We agree that it is important to focus on a company’s Board, but argue that we need to go beyond simplistic diversity quotas and consider instead the ‘character’ of a particular Board or executive team. It is to this element of firm governance that we now turn.

Restoring integrity and character

Prime responsibility for the changing culture rests with regulators (including politicians and lobbyists), with board directors and senior management, perhaps with an additional role for industry and professional bodies, and even educational institutions. Regulators have the responsibility to roll back the avalanche of poorly-functioning regulation that they have imposed and to ensure that supervision focuses on capability and integrity, and that documentation is adequate but not excessive.

Companies have the responsibility to ensure that employment practices value capability and integrity, and puffery and narcissism is recognised for what it is. All parties have the responsibility to resist pressures from the regulator to disempower them and impose spurious standards. One of the points made by Braithwaite (1998) is that one cannot have a hierarchical view of regulators, as “if the n+1th order
Virtue, hubris and risk culture

guardian is corrupt, the whole edifice of assurance can collapse”. The regulators themselves need active monitoring – not just by politicians.

Ultimately, responsibility for the promulgation of virtuous practice in an organization rests with the board of directors, given their key role in the selection of the CEO, incoming directors and indirectly, senior executives (Grant and McGhee, 2013). We concur with Grant and McGhee’s argument that the integrity of a firm, and the degree to which virtuous practice flourishes, will always be linked to the integrity and character of individuals in the board. Or as they put it, ‘good governance requires governors of good character.’ (p99).

Reducing dominance

Boards should be looking for integrity and competence when appointing CEOs. Of course, remuneration policies play a large role in justifying the “great man” of popular myth. Boards create hubris and narcissism by excessive and dishonest contracts that pretend to reward the unmeasurable. Remuneration packages should be much smaller and less dependent on spurious incentives.

Regulators do have the power to ensure that management of financial institutions are “fit and proper”, being one description of persons of character. They are not in a position to exercise that much power over appointments, but we suggest that much greater attention be given to this issue – and that they are active in ensuring that powerful personalities are required to move on by board renewal policies. They should also make it clear that they will use their power to ban egregious offenders from participation in the management of financial institutions. They can also use their fit and proper powers to ensure that enough senior people have sufficient experience to challenge inappropriate behaviour by dominant and often narcissistic individuals.

Analysis of surplus and manipulation of accounts

The standard methods of account manipulation are in accounting accruals, actuarial reserves and bad debt provisions. All are reliant on a set of assumptions that underlie the calculation algorithms. The strength of a complete actuarial-type analysis of surplus is that it monitors the validity of the assumptions and the impacts of changes. We suggest that it could have a higher profile in monitoring the integrity of a firm’s culture.

Changing behaviour

We note that individuals within firms or Boards can act virtuously, in spite of strong systems-related pressures, or norms of self-interest or narcissism. When faced with hostile cultural elements it is indeed possible to be ‘counter-cultural’ (Wilcox 2012). What is needed for virtuous practice to flourish, are circumstances where individuals can reflect on and question existing cultures and practices, with others who share similar concerns. MacIntyre contends that in practice, we need particular social settings, “milieus” which enable “reflective critical questioning of standards hitherto
Virtue, hubris and risk culture

taken for granted” (1999 p. 317). There is no reason why Board cannot themselves encourage these types of questioning spaces, where the capacity for ethical agency can be encouraged and developed amongst those who dare to question, out of the way of narcissistic behaviours.

Alongside the creation of opportunities for reflection and questioning of norms and taken-for-granted ways of thinking, there is also a need for individuals to develop their own capacity for self-awareness, which includes critical reflection and questioning of themselves. This quality, seen as a key element of authentic leadership, is often missing in the case of narcissists.

Conclusion

Reports on the larger financial failures of recent times (of which we have referred to HIH, NAB and the Equitable) invariably blame poor culture and dominant personalities, which we interpret largely as a failure of virtue – not formal risk management processes.

As Kyrtsis (2012, p50) reminds us,

“tendencies toward segregation between the world of regulators and the world of the regulated can undermine ongoing trust relations, and further reduce the effectiveness of informal mechanisms of cooperation.”

With this in mind, we have sought to move ‘beyond regulation’ and back to the essence of good risk management. In this paper we have suggested that risk culture should be reimagined as a matter of integrity and a steadfast opposition to hubris and narcissistic traits. If it is indeed a matter of integrity, justice, diligence and prudence, we suggest that the development of detailed rules has long been known as a very poor way to develop these virtues. Indeed it displays certain hubris on the part of regulators that they should even try.

References


Asher, A. with Trang Duncanson (2008). Developing a Fair and Reasonable Unit Pricing Restitution Policy, Presented to the Institute of Actuaries of Australia 4th


www.archbishopofcanterbury.org/articles.php/5075/listen-archbishop-justin-on-good-banks


**Appendix (from Braithwaite, 2009, 445):**

What could regulatory agencies have done to prevent the misconduct that led to the collapse of Enron, Worldcom and HIH? I made one suggestion at a meeting of the Australian Tax Office Aggressive Tax Planning Committee. I pointed out that two members of the Committee had separately said during my interviews that they had the following experience in the late 1990s. A Big Five partner got one of their wealthy clients into deep trouble for tax cheating. A more senior partner then visited the tax officer and said ‘This is a rogue partner and we are going to get rid of him. We would hate you in the Tax Office to think that other partners condone what he did’. My suggestion was that such an encounter creates a golden opportunity for the regulator to tackle the ethical climate in the major accounting firms and investment banks. So, I argued that the senior tax officer should reply:

That’s good that your other partners do not condone this and I’m pleased to hear it because we at the Tax Office were disturbed by the non-compliance that occurred here and are always concerned with something of this gravity that it might reflect a
culture of non-compliance in your firm. Could we have a meeting to discuss this with all your partners?

When they agree to this, and regulatory experience with restorative justice elsewhere suggests that they would (Parker 2004), it would be requested that the meeting be facilitated by a restorative justice practitioner. This facilitator would insist that the ‘rogue’ partner who was about to be scape-goated also attend. She would be the first person asked to speak by the facilitator. She would tell, in her own words, how the incident that got her into hot water had occurred. It might turn out, if this were Arthur Andersen, that the ‘rogue’ partner was not a rogue partner at all, but a fall-guy, who was actually following the culture of the firm. Then, in the conclusion to the conversation about the harm that has been done, when everyone in the restorative justice circle is asked what they think should be done to ensure nothing like this happens again, if someone else has not already suggested it, the regulator could request an audit of the firm’s systems for compliance with ethical standards. That independent evaluation of compliance systems would be conducted by a consultant whose independence enjoyed the confidence of both the firm and the Tax Office. Its recommendations would be reported back to a reconvened meeting of the restorative justice circle, which would discuss whether they went far enough. It would normally be made public for the purpose of catalysing wider crime prevention. A year later, the circle might be convened again to receive a report from the accounting firm and the consultant on how thoroughly the reforms to the compliance culture had been implemented. Active engagement of an errant Arthur Andersen with such a restorative justice process is enabled by the Tax Office being able to threaten the licence of an Arthur Andersen to offer tax advice. Without the power to escalate to corporate capital punishment by negative licensing, firms might not cooperate with restorative justice.

The Tax Office was one of a number of Australian regulatory agencies receiving reports of dubious ethics by Arthur Andersen in the late 1990s. So, there were multiple agencies on multiple issues with an opportunity to catalyse a major ethics self-examination of Arthur Andersen before their conduct brought down companies like HIH, Enron and itself. It would be surprising if that were not also the case with US regulators. The beautiful thing about this regulatory strategy with global firms is that, even if it has no appeal to US regulators, there is a possibility that its application by the Australian Tax Office to Arthur Andersen’s ethically questionable profit shifting into tax havens on behalf of Australian firms might have lifted the lid on similar work it was doing for firms like Enron in the United States. The more regulatory agencies around the world that were using restorative justice in this fashion on the Arthur Andersens and Enrons, the more unethical firms like these would have their ethics globally exposed. The ethical exposure of Enron in turn might have exposed other masters of the universe.