



# Virtue and risk culture in finance

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## **Virtue and risk culture in finance**

### **Abstract**

This paper suggests that devastating, but avoidable, organizational failures in the financial sector are often not so much a consequence of business risks but of an absence of business virtues in leadership cultures. 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 two important 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 with a conscious concern for its social purpose and the value of entrepreneurial activity. Secondly, its cultural model fails to distinguish the descriptive from the normative. It consequentially has no basis for the diagnosis of dysfunction, and the promotion of more ethical behavior resulting in the piling up of regulations that can constrain both good and bad behaviors. We suggest a virtue ethics framework that that supports aspiration to the virtues –particularly the justice and integrity that are missing from many organizational cultures. – while recognising the need for restorative justice because mistakes are inevitable.

**Keywords:** risk management, risk culture, virtue ethics, governance, integrity, complex systems.

## Introduction

Since the recent financial crisis there has been a widespread sense of a “crisis of governance” , and a failure of ethics and risk management. In the UK and the USA, the ensuing failures of the banking system (and the later LIBOR scandal) resulted in wide-ranging government-backed enquiries – including the UK Parliamentary Commission on Banking Standards (2013) and the Financial Crisis Inquiry Commission (2011) respectively. The G20’s Financial Stability Board’s (2013) also issued a report. These and other inquiries pointed to systemic flaws such as regulatory failures, but also to failures in management and governance within financial services organizations. Underpinning these organizational failures were destructive and self-serving organizational cultures, particularly in the two realms of leadership and the management of risk. Moreover, in spite of these upheavals and the ensuing critiques there remains, in the eyes of many, an “unresolved cultural crisis” in the financial services sector (Llewellyn, Steare and Trevellick, 2014, p. 8; see also Cohn, Fehr and Maréchal, 2014).

Given the harmful consequences of these events, and the ongoing impacts on millions of individuals globally, there is a clear need for a deeper and more nuanced understanding of cultures in the finance industry, and for an explicit consideration of the ethical dimension of culture (Nielsen, 2010; Weitzner and Darroch 2009; Moore, 2005). Whilst there is an emerging literature dealing with *leadership* culture and ethics (Ardichvili and Jondle, 2009; Mayer, Aquino, Greenbaum and Kuenzi, 2012; Sama and Shoaf 2008), there has been less scholarly exploration of how risk management and ethics intersect. It is this latter question that forms the focus of this paper.

Like many managerial fields, risk management starts off with scientific certitude, which is gradually expanded to give proper place to human qualities and the uncertainty of real life. Stultz (1996) provides an example of enthusiasm in seeing risk management in terms of financial engineering and managerial incentives. Being more complex and resistant to quantification, the shape of *real life* takes more time to emerge. Gephart, Van Maanen, and, Oberlechner (2009) explain this change in terms of the transition from modernity to late modernity, although it may also be seen as a personal transition from naivety to wisdom.

Risk culture can be interpreted to include attitudes to risk and business in general, but in this paper the primary concern is the *norms* that govern risk management, and what those norms suggest about the “organizational character” (Moore, 2005) of financial institutions and related organizations.

The very idea that risk should be managed (which underpins regulatory approaches to risk) is itself normative (cf. Roberts, 2001). Recognising this highlights the need to uncover underlying assumptions as to the objectives of

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risk management, and what ultimately constitutes what ethicists term 'the good life'. These assumptions underlie legal and moral obligations to creditors, policyholders and depositors – obligations that cannot be met if companies act recklessly. As we have seen in the cases of organizational failure in the financial sector, the consequences of poor risk management are the harms suffered by innocent third parties.

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 returns (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. Cultures also play a role in promoting (or limiting) harmful practices, for example in instances of socialization of new members (of boards of directors, executive teams, trading teams) into value sets 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 Australian bank NAB, for example, young traders were socialized into a culture where, according to Australian Prudential Regulation Authority (APRA) investigator David Lewis, "risk management controls were seen as tripwires to be negotiated rather than presenting any genuine constraint on risk taking behaviour" (cited in Fagg, 2005).

This conceptual paper provides a foundation for exploring risk management and culture through the lens of virtue ethics. In what follows, we affirm the growing acceptance of the central role of risk culture in the prudential management and regulation of in a complex adaptive risk system. Attempts to address questions of culture and ethics mechanistically have limited efficacy, as evidenced in current approaches to regulation as control mechanisms external to the system. A more fruitful approach would recognise the complexity and the 'contingencies', especially in the motivation and behavior of people, and frame the issue in terms of moral expression and virtue ethics. To this end a model of the virtues that adapts and extends many conventional approaches to ethics is applied at both the individual (leadership) and the organizational (culture) levels. Together with the theory of responsive regulation, we suggest that virtue ethics provide the most promising approach to shifting attitudes, behavior and risk culture (or character) to recognise fully the legal and moral obligations of financial organizations. A virtue ethics lens also considers how the financial sector can reorient towards an overarching purpose (or *telos*) which includes the pursuit of common and individual good in some form<sup>1</sup> (Arjoon, 2000) and also what philosopher Alasdair MacIntyre (2007) has called the 'internal goods' of excellence in practice.

## Conceptualizing risk systems and cultures

The risk system comprises an array of institutions and actors, each with their own interests and role to play within broader and more complex economic (and social) systems. Regulators, insurers, boards, senior executives, operational employees and the public are all part of this system. In many senses it functions as a *complex adaptive system* (cf. Foster, 2005), which can be defined as “a large collection of diverse parts interconnected in a hierarchical manner such that organization persists or grows over time without centralized control” (Eidelson, 1997, p. 43). Such systems are “embedded by a particular structure of connections” and “capable of reconfiguring their connective structure” (Foster, 2005, p. 875). This extended and nuanced understanding of the risk system and the entities comprising it enables a more accurate view of the role of governance and control mechanisms that aim to shape those same systems.

Complex systems provide challenges for those interested in bringing about lasting and positive change. This is because changes in one part of the system can have non-linear effects and impacts that are difficult to predict elsewhere in the system. Positive and negative feedback loops are typical, and impacts may be distant in both time and place. It is for these reasons that leaders may fail to foresee the existence of ethical issues. Sense-making practices, which are influenced by the logics and mental models that predominate in a particular business context, can also render moral dilemmas “invisible” to leaders (Werhane, 2008).

For these reasons it is important to step back from complex systems to get a sense of how the various elements relate to, and affect, each other and the system as a whole, or as Meadows (2009, p. 170) puts it, “get the beat of the system”. Meadows also emphasizes the importance of critically reflecting on dominant mental models. In the finance-risk system such an approach would have particular value. Such an approach to ‘systems thinking’ would be supported by Enderle (2000, p. 414) who urged a more nuanced view of economic (and social systems), arguing; “[b]eyond their relevance for explanation, more differentiated sociocultural assumptions in economic models are also of normative-factual importance, for, often, 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”.

For example, as Heath (2010, p. 136) points out, agency theory is premised on a “normative theory of practical rationality” that categorizes, for example, moral rules and cooperation as “irrational” and opportunistic self-interested behavior as “rational”. Heath goes on to give evidence that this is true of economics graduates and concludes by describing the modern firm as one “in which the dominant assumption is that “it’s every man for himself”... [and]

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that would not only encourage unethical behavior, but could become positively criminogenic" (p. 138). In essence, Heath is pointing towards the kind of 'toxic cultures' that both the UK Parliamentary Commission on Banking Standards (2013) and the US Financial Crisis Inquiry Commission (2011) exposed. There are numerous examples of this type of toxic culture in the recent history of Anglo-American economies.

One such example was the collapse of Australian insurance company HIH. In the report of the ensuing Royal Commission, Justice Owen (2003, p xvii) concluded:

*A cause for serious concern arises from [the company's] corporate culture. By "corporate culture" I mean the charism or personality – sometimes overt but often unstated – that guides the decision-making process at all levels of an organization. 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 organization 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

From the extensive body of literature on organizational culture (e.g. Di Maggio, 1997; Schein, 1996, 2010) there is a broad understanding that cultures are embodied in both material and symbolic practices. These include formal routines and standards, informal behavioral norms and expectations, and the 'interpretive schemes' or worldviews through which people make sense of the world. Multiple cultures and subcultures can exist in organizations, as can distinct professional cultures and norms. Organizational cultures and subcultures also reflect elements of the national cultures in which they are embedded. For this reason it is misleading to talk of a single, unitary 'culture' in a firm, although there may be certain characteristics that distinguish one firm from another. Moreover, organizational cultures and the actions of organizational members are recursively related, in other words, *cultures shape and are shaped by what people do.*

Moore (2005) argues that there is confusion over the use of the concept of culture because it has to bear the weight of more than one meaning, particularly normative evaluations. We describe below two alternative approaches to describing culture, both of which have proved useful in explaining a variety of organizational practices, but neither of which have explicitly addressed normative questions.

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Fiordelisi and Ricci (2013), use a model of organizational culture based on the competing values framework of Quinn and Rohrbaugh (1983). This literature identifies three dimensions of corporate value orientation: flexibility/stability, outward/inward focus and means/ends. Ignoring the means/ends axis produces four quadrants, which can be described as:

- *Control* (internal, stability) valuing procedures and conformity and measured by efficiency and smooth functioning
- *Collaboration* (internal, flexible) valuing trust and communication and measured by employee satisfaction
- *Creation* (external, flexible) valuing autonomy and measured by innovation
- *Competition* (external, stability) valuing achievement and measured by market share and profitability

While these are referred to as competing values, Denison and Spreitzer (1991) suggest rather that they are ideal types that are likely to be found within the same organization and that, “when one quadrant is overemphasized, an organization may become dysfunctional” (p6).

Hofstede (2001) describes a widely used model of national culture along the dimensions of uncertainty avoidance, collectivism/ individualism, power distance, and masculinity/femininity. The dominant national cultures of financialised capitalism are Anglo-American (Moore, 2012). Hofstede’s dimensions can be seen as a purely descriptive of national preferences, but studies such as Zheng et al (2012) find that increases in these dimensions tend to lead to shorter term corporate debt in national financial markets, with potentially inefficient outcomes, and which would also be likely to contribute to systemic risks. For example, uncertainty avoidance appears to lead to shorter term debt because it allays feelings of uncertainty, rather than a more rational evaluation of the risks. Power distance is thought to undermine trust and long term investing. Against these negative consequences, they suggest that collectivism would mitigate overconfidence in individualistic societies – in the taking of more long term risks for the wrong reasons.

We return to the idea that some elements of culture are not normative, or certainly not universal. Donaldson and Dunfee (1994) propose “Integrative Social Contracts Theory” as a framework for understanding the normative nature of the social contracts, and culture, underpinning institutions. They suggest that much organizational culture exists in a “moral free space” as “concepts of business ethics vary significantly from culture to culture, as well as from time period to time period”. Conceptions of the good can be personal or shared by some communities and not others. They then however go on to suggest the universality of “hypernorms”, which they would identify through a “convergence of religious, philosophical, and cultural beliefs”<sup>2</sup>.

Following on from this multi-faceted understanding of organizational culture, *risk culture* can be understood as comprising the routines, norms, behaviors and worldviews (interpretive schemes) that relate to risk taking and its mitigation (cf. Ashby et al, 2013). The approaches to risk within and amongst organizations are expressions of broader, dynamic sets of cultural factors. Risk culture is a central element of governance systems, as important as regulatory structures or external institutions. 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 Ashby, and Palermo, 2013). In their recently released study of risk cultures in the British financial services industry, these researchers found that while the concept of risk culture was “rather fuzzy” (2013, p. 2), 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.

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. This view runs counter to the argument that risk cultures form part of a complex, evolving risk system. Assumptions that risk cultures can be simply ‘designed’ or engineered betray the mechanistic world view of many approaches to risk management, (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 reify<sup>3</sup> the complexity and messiness of organizational strategies and culture (note the proper noun status in the above quote) and are premised on an unproblematic notion of “fit” between strategy and organizational practices. In practice, risk systems cannot be managed in such a mechanistic fashion. Part of the problem is also that risk has widely different valence. In the literature on culture cited above, risk aversion is seen as largely a matter of perception and personal preference, with no normative elements. A large literature, stemming from Jensen and Meckling (1976), is aimed at addressing the agency problem of “managerial risk aversion”, on the assumption that managers do not take enough risks and incentives need to be designed to overcome this risk aversion. Regulators lean towards seeing risk aversion as ethically neutral as long as it is clearly defined and adequately managed. This however does not address the question of whether people and organizations can be reckless, problems which can be linked to dominant personalities and empire building.

### **Dominant personalities**

The degree to which individual executives or board members come to dominate risk-related decision-making is an important element of risk culture



that is often only acknowledged after catastrophic organizational failures. 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.

In the H1H case mentioned earlier, the Royal Commission identified the contribution of “dominant personalities” (in particular that of the CEO, Ray Williams), to the firm’s eventual failure,. The risk systems were adequate in this case 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 (2004, p. 741) describing the Chief Executive “an idiosyncratic and autocratic individual ... without significant control by his colleagues, his board or the regulator”<sup>4</sup>. 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 (Grant and McPhee, 2013).

The problem of dominant individuals – and the associated suppression of critical questioning – was recognized in the recent report of the Financial Stability Board (2013), the peak international body appointed by the G20, which suggested better succession planning was needed. The International Actuarial Association (2014) extended the FSB response<sup>5</sup>, arguing that:

*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 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).

In sum, risk cultures are manifestations of organization cultures and are shaped by the actions of powerful actors including CEOs and boards of directors. Such cultures in turn shape the behaviors of organizational members. All of this forms part of an overarching, complex and evolving ‘risk system’ in which unintended consequences of actions can be overlooked. Recent ‘catastrophic’ events within the finance sector can be linked to the failure to consider system complexity and associated positive and negative feedback loops. The next section considers conventional responses to such events and and highlights some of the inherent flaws in these responses.

## Responses to failures

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.

The adoption of a complex systems perspective on risk management and cultures exposes the shortcomings of conventional 'rules-based' and 'external' methods for mitigating risk in the financial sector. Many of the regulatory 'solutions' to problems with risk culture have been based on flawed assumptions. As representative of the best of this, we refer to the Financial Stability Board's (2013) consultative document on risk culture. This particular document goes to some pains not to "define a "good" or "bad" culture" (p 1), on the grounds of different national cultures, but does not thereby avoid its essentially normative nature<sup>6</sup>.

To the FSB and many national regulators, 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, elaborate models and separate functional areas for risk. We suggest that this approach, with its reliance on 'fixing the component parts' and 'pulling control levers' and little consideration of rather than on relationships, feedback loops and ultimate causes, is based on a mechanistic view of the firm. In the FSB (2013) document, for example, focus is on "financial institutions" risk governance and internal controls, risk management functions, as well as risk aggregation and risk reporting capabilities" (p i). The word "consequence" appears four times, but always in relation to consequences for non-compliant behavior rather than the consequences for third parties of poor risk management.

### Excessive detail

This mechanistic and compliance driven outlook has resulted in the explosion of documentation and prescription driven by the assumption that regulators (or top management) can change the culture by rule making. Whilst regulation is acknowledged as a necessary component in any risk system, problems arise when regulation is over-elaborate. Within this paradigm, Bozeman, and Kingsley (1998, p. 111) argue against "a highly formal, bureaucratized organization that is too entangled in its procedures, internal controls and processes to sustain risk". These authors found that high levels of

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internal delegation of power (including reward for taking risks and clarity of objectives) and lower levels of bureaucratization were related to a higher propensity to take desirable risks.

In Australia, the Common Prudential Standard CPS 220 (APRA), 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 should however be a means to an end. 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.” (APRA CPS 320)

The real question is whether the regulated entities are actually managing the risk. Looking at how they inform shareholders is one test. For example, the 2013 annual report of one of Australia's largest banks (Commonwealth Bank of Australia) can be read as 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. 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<sup>7</sup>.

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. We would argue that part of this scope needs to include an overarching sense of the organization's purpose or *telos*. 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, Ashby, and Palermo, 2013). Welby is essentially appealing to bankers and others in the financial services industry to cultivate *virtues* that would engender positive cultures where hubris, narcissism and groupthink are left behind. This idea of virtue will be expanded on later in this paper.

## **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. 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), who claim that the complex and prescriptively detailed models do not work as well. 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.

Power (2005, p. 595) views the idea of operational risk as a “fantasy perhaps, of hyper-rational management.” Regulators would lose little by removing the capital requirements from regulation, and regulated institutions gain significantly by limiting their efforts in this area to the bare minimum. Models are at best illustrative and organizational failures are not prevented by the adoption of ever more complex financial models. What is needed are managers and finance professionals who have an overarching sense of purpose or ethos (Llewellyn, Steare and Trevellick, 2014), and are committed to developing an expert understanding of the underlying forces, and responding appropriately.

The issue of complexity of the system and the need to avoid a mechanistic view of the relationships also applies to the financial markets in which institutions operate. In an interesting and prescient paper, Holzer and Millo (2005) argue that regulatory frameworks that attempt to incorporate risk assessment tools are fundamentally flawed when they fail to take into account the “second order changes” created by risk management practices themselves. Moreover, Kyrtis (2012, p50), for example, has pointed out that “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.”

## Management remuneration

The simplistic and mechanistic view of governance is perhaps nowhere more evident than in management remuneration and the literature of agency losses and incentive alignment. In the first place, there is considerable evidence, some of which is summarised in Alces and Galle (2012), that the structure of managerial incentives have failed to achieve the alignment required – partly because of excessive cognitive complexity and partly as a consequence of managerial power used to manipulate boards into giving excessive remuneration. Alces and Galle question the ability of executives to determine the precise relationship between their remuneration packages and the decisions they make. These are however relatively easy decisions compared with those that the board has to make in designing the incentives to maximise firm performance. Can one really evaluate – even approximately - the impact of any one individual on true “performance”? In spite of the shortcomings of Anglo-American approaches to incentivization, the 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 behavior has to be addressed before it does damage. It is plausible 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. Moreover, excessive remuneration of finance industry executives may feed the rise of dominant personalities – paid so much more than their colleagues, who are thus increasingly unable to question them.

Finally, the adoption of a systems perspective gives rise to a broader perspective on governance, similar to that proposed by Sapelli (2013, p. 87) who describes governance as “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”. Such an approach paves the way for ethics to be embedded in governance systems (cf. Moore, 2012). Ashby, Palermo and Power (2013) observe that “both ethics and incentives can be used as mechanisms for behavioral change”. Ethics is, however, undervalued by what these authors call the “trans-organizational regulatory culture”. The following section presents a pathway for moving beyond this over-reliance on external controls and models, through the branch of ethical thinking known as ‘virtue ethics’.

## **Virtue ethics and character: An alternative perspective**

We now turn to the development of a normative framework with which we can evaluate aspects of culture that are dysfunctional or dehumanising. As we have argued, risk management is a normative exercise, and is thus as much the proper study of ethics as of statistical technique, and of law as well as economics.

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. Virtues are developed through action, and ultimately lead one to what Aristotle termed 'the good life' – for oneself and for others (McPherson, 2012). They are aspirations that (almost) everyone who has thought about them, would want to achieve and are seen as the means through which individuals can attain 'the good life', or human flourishing.

Various philosophers have sought to identify the 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). In what follows, we attempt to produce a framework by which they can be discussed and applied.

Recent work by positive psychologists (interested in human flourishing rather than pathology) (e.g. Dahlsgaard et al., 2005), has led to significant convergence on some concepts<sup>8</sup>. In one such study, (McGrath, 2015) the results of over a million respondents from 75 countries are reported whereby "[e]ven the smallest correlation ... of ranked strengths that emerged in this study meets the common standard for a large effect" (p51). McGrath (2014), identifies 23 strengths, which are clustered into five "factors":

- *Interpersonal: Fairness, Forgiveness, Kindness, Receptivity, Teamwork, Modesty, Love*
- *Emotional: Kindness, Humour, Social IQ, Creativity, Bravery*
- *Intellectual: Intellectual Pursuits, Love of Learning, Beauty, Curiosity*
- *Restraint: Judgment, Perseverance, Perspective, Honesty*
- *Future Orientation: Positivity, Future-Mindedness, Self-Regulation, Spirituality*

It would appear that these five clusters resemble the four *cardinal virtues* of justice, courage, practical wisdom and self-control – which derive from Plato and Aristotle. Each of these will be considered in turn.

- *Justice* is traditionally defined as giving other people their due; treating them fairly. It is the virtue that governs the use of power over others. Society legislates minimum standards for justice, but we have higher aspirations. It seems be linked fairly obviously to the interpersonal strengths

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listed by McGrath, and also to honesty, which comes close to being included here.

- *Courage* is what is required to protect ourselves. MacIntyre (2007) suggests before in primitive societies, physical courage and strength were seen as the major virtues<sup>9</sup> but the physical becomes less necessary in settled societies. It appears that McGrath's internet respondents aspire to emotional courage as expressed in social IQ and even humour, and the courage to innovate.
- *Practical wisdom* is making good decisions in the face of uncertainty, and sometimes opposition. It is clearly intellectual and traditionally incorporates the other strengths listed except for beauty. McGrath's beauty, however, also incorporates "awe, wonder and elevation", which perhaps do correspond to a delight in truth and understanding that do go with wisdom.
- *Self-control* both curbs our inclinations to excess and cultivates, by practice, the habits of a good life. It would traditionally have been seen to be linked more to restraint than future orientation, but Mischel (2014) reports on a variety of studies on the psychology of self-regulation that relate it strongly to the ability to defer gratification. His wide-ranging research identifies some of the contribution of nature, nurture and training to the abilities to exercise self-control, noting also that people's responses – and indeed their ability to resist temptation – are considerably influenced by the situation in which they find themselves.

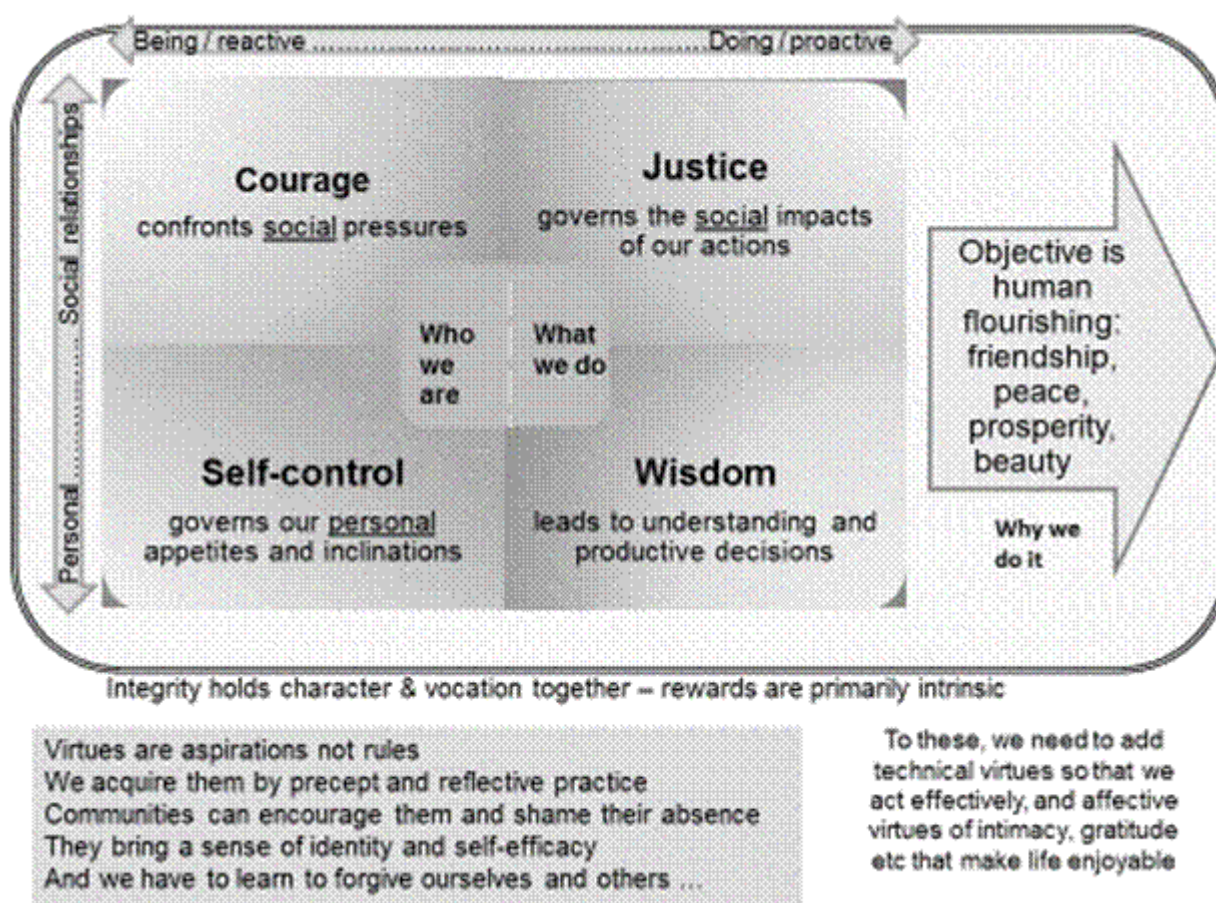
Scottish philosopher Alasdair MacIntyre (1999) has argued that the virtues of *integrity* and *constancy* underpin the possession of the other virtues, and are particularly important in business contexts, where decoupling of responsibilities can prevail. By integrity, he means remaining true to oneself 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'.

Solomon (2003) reminds us of the normative nature of virtues, adding that "they are not mere behavioral tendencies" (p 48). Virtues transcend "personality", and they also transcend the assumption that the context (or system) *determines* the action choices available to an individual (Wilcox 2012). Mischel's (2014) research is persuasive that, while some people have greater ability to self-regulate, the ability is not consistently applied to different situations, that people do behave consistently in similar situations, and that it is within the power of each of us to make decisions about our conduct. This provides a counter to Harmer's (1999) view that it is a fundamental error to attribute any behavior to virtues of character on the grounds of inconsistency and that it is impossible to determine a person's underlying character. Alzola (2008) deals more thoroughly with the views of

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Harmer and others, in which he suggests that they misinterpret the evidence and the nature of the moral virtues.

It is possible to reconcile the aforementioned insights of Hofstede with those of Quinn and Rohrbaugh by mapping the various value dimensions to the cardinal virtues, with their associated normative requirements. We note that precise definitions are fraught both because the moral virtues have been used in such diverse contexts for so long. They are also used, by definition, in potentially contested contexts, because they only have meaning when they are seen as standards which are not being met in some way. They can however be conceptualised as setting standards for who we should be, what we should do, and why we should do it – both in ourselves and in society. Seen in this framework, Figure 1 represents how the traditional virtues can be seen to cover these questions — comprehensively.



**Figure 1 Personal character virtues (taken from Asher, forthcoming)**

The virtues are not entirely distinct and are mutually reinforcing. We can however see that the two virtues on the left (courage and self-control) are more related to influences on *who we are*, while those on the right (justice and prudence) relate to *what we do*. The top two (courage and justice)



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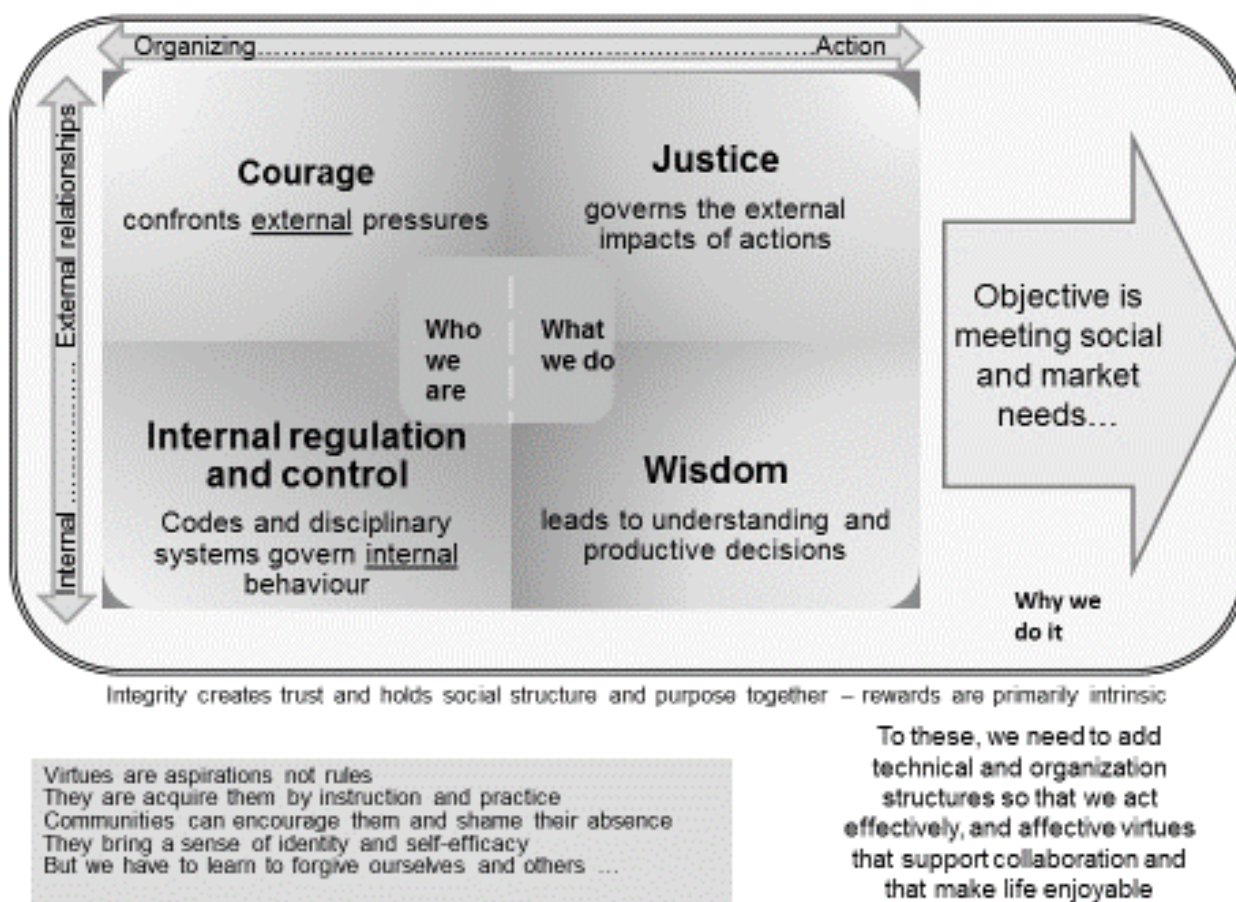
relate to relationship with others, while the bottom two (self-control and wisdom) are more personal. Illustrated by the line around the diagram holding everything together is integrity, the fundamental virtue. The arrow on the right indicates that our actions should build a community that encourages the development of the virtues, and allows all its members to flourish in the widest sense.

The virtue ethics of MacIntyre (2007) is more concerned with how to develop a good character as much as what constitutes right behavior and good outcomes. van Hooft (2014) gives more extensive coverage, showing also that there is a wide range of interpretations of virtue ethics. The structure shown in Figure 1 is a novel representation of the virtues that links them to ethical behavior (deontological theories) and outcomes (consequentialist theories). Whilst recognising the legitimacy of deontological categorical imperatives based on reason for the training of virtue and the ordering of communities, the view of virtue ethics is that our aspiration should be to want to do both the right thing and achieve good aims, and that rules cannot be made for all circumstances. Similarly, while recognising the value of the utilitarian calculus of the greatest good of all, virtue ethics is concerned both with character *and* means, and concerned with developing communities of where individuals flourish – in developing the virtues. Critical are the ‘internal connections’ between actor, act and consequences, of which intrinsic motivations are perhaps central.

### **Virtuous organizations**

The virtues should therefore be seen as finding their full flowering in community, and indeed are necessary for the development and maintenance, of community– of which business is an example. Organizations can be seen as an instrument for the achievement of the good life, but clearly also have something of a life of their own that transcends that of their members. It is not unreasonable to think of virtuous organizations as those that are motivated by a meaningful social purpose that – justly – takes the aspirations and expectations of all stakeholders into account (Collier, 1995). Such organizations have “appropriate and efficient decision-taking structures in the face of internal and external pressures” and managerial practices “in which people find it possible to find meaning and fulfilment in excellence as defined in performance terms” (1995, p. 147).

Her description does lend itself to be considered it in terms of the four cardinal virtues as structured in Figure 1. Figure 2 provides such a representation.



**Figure 2: Corporate cultural virtues**

Clearly the social purpose and requirement for justice remains. The organization may have greater capability but it is difficult to see how it might have moral obligations that differ from an individual. The internal processes need to perform the same functions of control of 'internal and external pressures', although they are clearly entirely different to individual virtues. That would leave wisdom as the managerial process of ensuring that the needs of internal stakeholders particularly are met and fulfilled, and that they all play their proper role.

Do these compare with the Quinn and Rohrbaugh (1983) quadrants? As with the comments of Denison and Spreitzer (1991), while some people and organizations may be stronger in some of the values, they are all desirable. The internal/external dimension is retained, but the flexibility/stability dimension is replaced by an organising/action dimension. A mapping might be achieved if flexibility and action were contrasted with organization and stability.

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Rather than attempt to find a tight fit, it may be worth exploring the associations that such a mapping creates. Control is in the expected place; as is competition and courage. Wisdom is aligned with collaboration, which may seem unexpected, but not if one considers it is internal to the organization and is associated with words such as caution and logic<sup>10</sup>. Creativity is difficult to reconcile with justice, however, although it could perhaps be mapped to the arrow and the social objectives of the organization. The arrow on the right might alternatively be analogous to the means/ends dimension.

The pieces missing from the other theories of culture are therefore justice and the foundational virtue of integrity – both of which are universal norms, partly enshrined to greater or lesser degrees in all legal systems. What is clear from recent events, however, that it is precisely failures of these virtues that have contributed to the financial crisis; this calls for an extension of the conceptualisation of culture to incorporate these values explicitly.

Business and government organizations are valuable social structures; at their best creating prosperity and providing communities where individuals can flourish. On the other hand, they can be places of manipulation and exploitation both internally and externally – particularly if limits are not recognised. The personal virtue of justice requires a recognition of the dignity of all within community; organizations where people are not respected, but manipulated and coerced into unjust or dishonest behavior cannot be virtuous. It is of course true that there are times when an organization cannot serve its social purpose without significant constraints on those who are serving within it. We would however hold that a central tenet of justice is that all people have an equal right to dignity. Each such claim needs evaluation on its merits: the possibility that it is manipulative is always present.

Risk culture fails when inappropriate informal behavioral norms and expectations override the virtues as suggested in Table 1, which considers the elements of culture mentioned by Power, Ashby, and Palermo (2013).

**Table 1 Risk management and virtue**

<b>Elements of risk culture (Power et al 2013)</b>	<b>Corresponding Virtue</b>
“restore trust” (12)	Integrity – being trustworthy
“meet customer needs” (12)	Justice – giving all their due
mitigate “deviant subcultures” (13)	Self-control
“over-confident corporate risk-taking”	Justice – failure to avoid harm
“‘brash’ and aggressive ‘tones from the top’,” (13)	Wisdom or prudence
“breaches ...routinely disregarded” (13)	Integrity
“introspection, lack of insight or sufficient self-criticism, rejection of external criticism” (14)	Wisdom
“above all fear” (14)	Courage
“complacency... There are recurring themes of missed warning signals, failure to share information.” (14)	Integrity

### **Restorative justice and risk cultures**

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.

Risk cultures must go beyond awareness, to being quick to acknowledge and correct errors. This entails an admission to being prone to making mistakes, a quickness to admit when they are wrong, and correct and often to forgive them. Many huge losses can be blamed on failure to ensure that there are

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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".

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.

## **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.

Sitkin and Pablo (1992) provide a conceptual framework for risk behavior that sees it as the consequence of the decision makers' perception of the risk and their propensity to take risks. Risk propensity is in turn affected by personality

and experience, while risk perception is based on a cognitive factors, such as framing and expertise, which are partly personal and partly organizational. Subsequent research has found the framework to have empirical validity (Huff and Prybutok, 2008 and Hamid et al, 2014), and it is particularly helpful in identifying those elements of the decision process that are subject to intervention. In particular, they can identify problem framing, social influences and what the extent to which organizational control decisions are process rather than outcomes orientated.

### **Restoring integrity and character**

Developing and sustaining a virtuous organizational culture firstly requires an explicit commitment to the virtues. Mischel's (2014) research on self-regulation makes it clear that people respond positively to the affirmation of virtuous standards. While necessary, it is clearly not sufficient, as it brings with it risks of hypocrisy and tedious sermonizing. Such affirmation therefore requires acceptance from as many people as possible, especially from those with larger responsibility: regulators (including politicians and lobbyists), with board directors and senior management, with an additional role for industry and professional bodies, and even educational institutions.

Neither traditional views as to the development of virtue, nor modern psychological research on appropriately regulated behavior gives any support for the notion that risky behavior can be curtailed by the multiplication of rules. Regulators have the responsibility to roll back the avalanche of poorly-functioning regulation that they have imposed, to ensure that supervision focuses on identifying the failures listed in Table 1, and challenge management to adopt more virtuous practices.

Managers 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 (1999) is that one cannot have a hierarchical view of regulators, as "if the n+1th order guardian is corrupt, the whole edifice of assurance can collapse" (92). 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). Bass and Steidlmeier (1999) explore the characteristics of

transformative leadership from a virtue ethics perspective, noting the temptations to manipulation of others but failing – on their own admission – to resolve the tension between those holding primarily libertarian and those with a communal orientation. We see the solution in acceptance of a personal virtue of justice and organizational wisdom that acknowledges mutual accountability that remains entirely sceptical at the very concept of inspirational leadership. As Gini and Green (2013), remind us, “[l]eadership, 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.”

### **Reducing dominance**

Boards should be looking for integrity and competence when appointing CEOs. As we have noted earlier, 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. Mischel (2014, p. 195) captures this hubris well, observing that “[their] optimistic illusions and inflated self-worth, shared with the rest of humanity but perhaps even more grandiose in them, made them feel invulnerable”. For this reason we have argued that 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 behavior by dominant and often narcissistic individuals.

### **Developing integrity in reporting**

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 Sarbanes-Oxley in 2002. Dichev, Graham, Harvey, and Rajgopal (2013) found that the CFOs surveyed believed that 20% of companies in the USA are still manipulating accounts. Manipulation of earnings occurs in attempts to influence stock price, or hit

earnings benchmarks, and also to “avoid adverse compensation and career consequences for senior executives” (Dichev, Graham, Harvey and Rajgopal, 2013, p. 3).

Clout, Chapple and Gandhi (2013) suggest 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 in their study. This suggests an important role for governance and ownership structure for the culture of the firm as manifested in the earnings quality. It is suggested that both shareholders and regulators have an interest in more accurate reporting of earnings, and that there are relatively simple methods of identifying misrepresentation fairly soon after it has occurred<sup>11</sup>. The board, management and their auditors need to be brought to account, if necessary by naming and shaming.

### **Changing behavior**

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 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 behaviors.

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.

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 is seen as a key element of ‘authentic’ leadership (Avolio and Gardner, 2005).



## Conclusion

As we have seen, reports on the larger financial failures of recent times invariably blame poor culture and dominant personalities, which we interpret largely as a failure of virtue rather than of formal risk management processes. In this paper we have argued for an approach to risk management that recognises that risk cultures form part of a complex, evolving risk system. External control mechanisms built on reductionist assumptions are less likely to be effective than the fostering of virtue in the finance industry. To this end we have presented a model of virtues that can be applied to individual finance professionals and more generally to cultures.

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 is a poor way to develop these virtues.

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## Endnotes

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<sup>1</sup> Aristotle labelled this purpose (or good) of human life as eudaimonia (Moore, 2005).

<sup>2</sup> They suggest the United Nations' Universal Declaration of Human Rights as a possible foundation, recognising the human right to dignity as well as the more concrete rights to life, freedom and property. These are however very general and apply mainly to the health and safety aspects of risk management. (<http://www.un.org/en/documents/udhr/>)

<sup>3</sup> Incorrectly render an abstract and socially constructed phenomena concrete.

<sup>4</sup> Joint positions, such as Roy Ranson's at the Equitable, and joint chief executive and board chair are recognised as a source of risk. In addition, the influence of CEO duality may reduce the effectiveness of a firm's nomination committee.

<sup>5</sup> Which was arguably somewhat weak.

<sup>6</sup> The word "should" is used 26 times and the word "sound" 19 times in a document of 10 pages.

<sup>7</sup> There is another review due to be released in February 2015, and it will be interesting to see whether much has changed.

<sup>8</sup> These concepts can also be related to the 'hypernorms' discussed earlier.

<sup>9</sup> Consider Homer and Beowulf.

<sup>10</sup> See, for example, the text analysis performed by Fiordelisi and Ricci (2013), although it should be noted that the text analysis excluded words such as fairness, justice and equity.

<sup>11</sup> An actuarial analysis of surplus provides a check on all financial models by comparing actual to expected experience and separately identifying changes to assumptions.