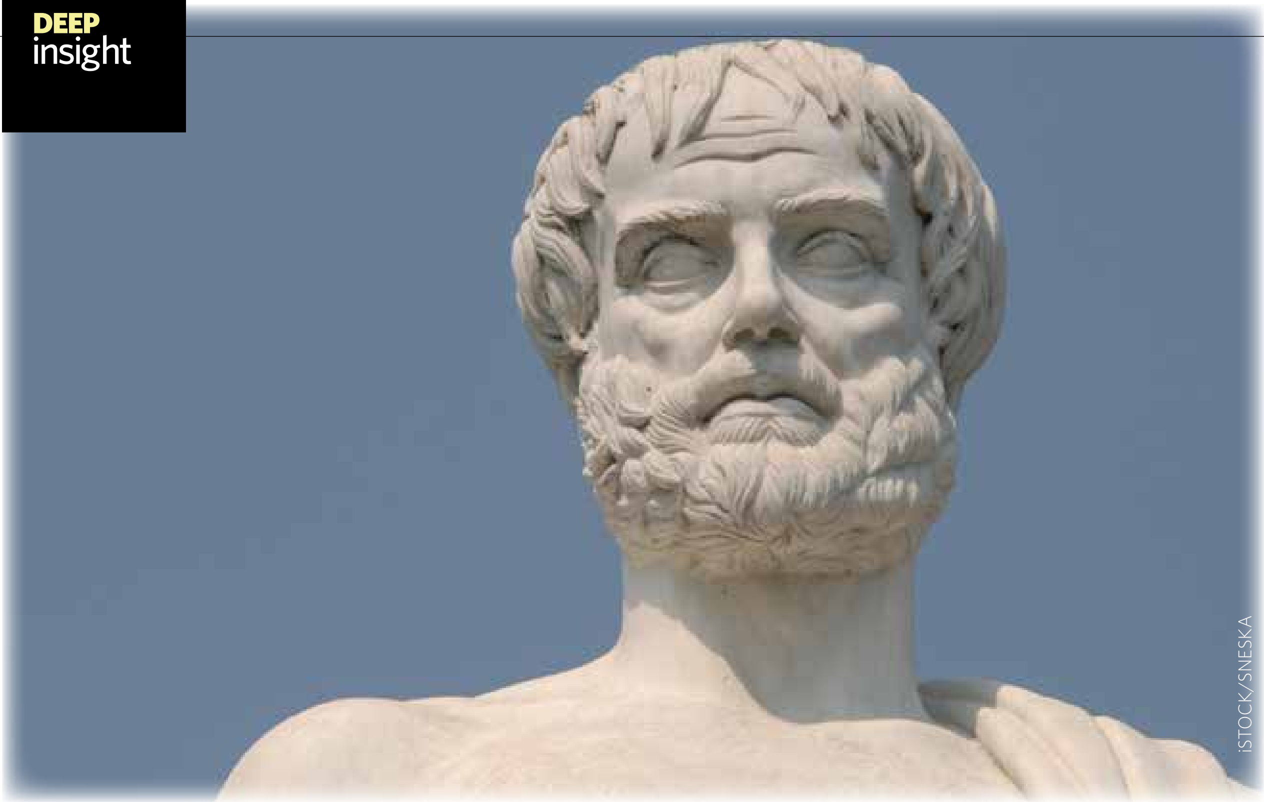
DEEP insight



A FRAMEWORK TO AVOID MORAL BANKRUPTCY

In Search of the Virtuous Banker

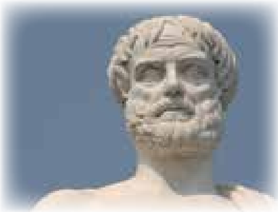
By CHRISTOPHER COWTON

On September 15, 2008, the investment giant Lehman Brothers filed for bankruptcy, the largest in U.S. history. Panic erupted on Wall Street, 25,000 Lehman employees were sent packing, and central banks mobilized to prevent contagion and to keep markets from plummeting.

Lehman's collapse – considered a watershed moment in the history of banking – accelerated the subprime mortgage crisis and profoundly eroded trust and confidence in the global financial system. While not the first banking crisis in history (and probably not the last), its scale and geographic scope had a shocking ripple effect throughout the system, inflicting serious economic and social pain.

At the same time, the crisis provoked a tsunami of commentary and criticism, including accusations of an apparent lack of ethics in the financial system and its principal institutions. Unfortunately, at that moment, there was no substantial body of academic knowledge on financial ethics that the global banking sector could turn to for guidance. And despite some encouraging signs over the past 10 years, the situation hasn't changed significantly.

In this article, I offer some ideas to advance the thinking on financial ethics in a way that I hope makes sense to banks and bankers. I begin with a brief overview of the standard measures used to improve the financial system and their potential shortcomings, as a prelude to showing how financial ethics, particularly in the form of virtue ethics, might fit in.



Formal Controls & Their Shortcomings

Regulations, corporate governance reforms and codes of practice were among the first solutions set forth when financial turmoil struck. While these formal controls are important, each has inherent limitations.

REGULATIONS. In the case of regulatory reform, changes to the incentives and constraints that govern financial institutions often look better on paper than in practice. Formulating detailed rules for complex businesses in dynamic markets is a difficult undertaking that often leads to bureaucratic burden and a climate of box-ticking, game-playing and loophole-spotting. In this context, the spirit and substance of the reforms in question are frequently undermined by following the rules to the letter.

Moreover, regulations encourage us to think in terms of policies and rulebooks. But, as any good leader knows, relying on a rule-based system is not a good way of managing. If you don't get people on your side and if the corporate culture works against the rules, people will always find ways around and between them. The regulator's problem is that its resources – financial and intellectual – are miniscule when compared with those of banks.

EXECUTIVE SUMMARY

Despite some progress over the past 10 years, the controls put in place to prevent another global financial crisis fail to address two key concerns: corporate culture and individual character. There's still a lot of work to be done to define and agree what makes a good bank as well as a good banker. The author, an internationally recognized scholar in business and financial ethics, believes a return to the ancient moral philosophy of virtue ethics is a good place to start. Using an exercise he devised for accountants, he suggests how those in the banking profession might likewise begin to rethink their assumptions, values and stakeholder relationships to come up with a more compelling sense of purpose than the profit-at-all-cost one that precipitated the Great Recession. The virtue framework he proposes can be beneficial for self-reflection, for recruitment and selection criteria, or for framing a staff development agenda. Don't let the lack of an internationally agreed code of ethics for banking stop you from becoming a virtuous banker.

CORPORATE GOVERNANCE REFORMS. The financial crisis also prompted a reexamination of corporate governance. This is perfectly natural if, to echo Bob Tricker's insightful distinction, corporate governance is about seeing that a company is run properly, rather than actually running it, which is management's job. Without a doubt, the renewal of corporate boards and the ongoing assessment of directors' responsibilities and activities are critical. Yet corporate governance is hard to get right, especially if incentives and expertise are not well aligned with needs.

CODES OF PRACTICE. Company and industry codes of practice provide a means of setting expected standards of behavior. The efficacy of codes, however, depends not only on their content but on their implementation and ongoing cultivation at all levels of the organization, as Simon Webley and Andrea Werner noted in their 2008 article, "Corporate Codes of Ethics: Necessary but Not Sufficient." In other words, it's not enough simply to devise a code of ethical conduct and just leave it to do its work.

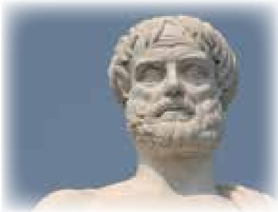
These formal approaches can make important contributions, but on their own they all underestimate the impact of culture, which, even if it doesn't always make or break formal controls, interacts crucially with them. What's needed is an overall control package that merges both formal components – which are relatively easy to change by administrative decree – with informal or social elements.

A truly ethical approach goes beyond mere rules. It not only fills in the gaps in formal systems but gives them life by instilling the spirit of rules and regulations in the corporate culture and in an individual's character. Embedded in culture and character, ethics can help avoid another financial downturn like the Great Recession of 2008, or at least reduce the frequency and magnitude of future crises.

So, what does, or might, ethics in finance look like? Before we get to that, we need to address another question first: is there really room for ethics in banks and banking?

Finding Space for Ethics

In global banking circles, particularly in Anglo-Saxon economies, the predominant discourse in recent decades has focused increasingly on



Some might say, "But we can't afford to be ethical." The evidence suggests otherwise. Being more ethical is not necessarily a bad business move and, on balance, might even be a good one.

shareholder primacy and shareholder value. When this becomes the overriding rhetoric, banks are framed as mere money-making machines, with little room for deliberations on ethics. Against this backdrop, what kinds of discussions are held at corporate board meetings? What issues shape their agendas and set the tone across the organization?

In the years preceding the financial crisis, this overly commercialized bent led many to consider ethics in banking a contradiction in terms, a view surely exacerbated by accounts of individual immoral behavior and the unethical selling of financial products by many banks.

At first glance, the opinions of two great economists, often pitted against each other, would seem to validate this view. After all, banks stand at the heart of the capitalist system, described by John Maynard Keynes in 1926 in these terms: "I think that capitalism, wisely managed, can probably be made more efficient for attaining economic ends than any alternative system yet in sight, but that in itself it is in many ways extremely objectionable."

Several decades later, Milton Friedman famously had this to say: "There is one and only one social responsibility of business: to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud."

In this context, one could conclude that shareholder primacy and market competition force out any consideration of nice-to-haves like ethics and corporate social responsibility, and leave much that is "extremely objectionable," to quote Keynes. Nonetheless, Friedman himself recognized that morally desirable actions were not always a drain on profitability but, in fact, might be positively aligned with it. He had no problem with this.

Some might say, "But we can't afford to be ethical." The evidence suggests otherwise. In a 2003 review of 127 broadly comparable studies, Joshua D. Margolis and James P. Walsh suggested a broadly positive link between ethical behavior and corporate performance. In "Corporate Social and Financial Performance: A Meta-analysis," Marc Orlitsky et al. reached a similar conclusion. Granted, these reviews were only picking up tendencies, but what they do affirm is that being more ethical is not necessarily a bad business move and, on balance, might even be a good one.

In short, the evidence indicates that the good guys don't always finish last or even near to last. They might even finish first or thereabouts. There is space for ethics in a competitive environment, even if it's a constrained space. This fits with our everyday experience: who do we prefer to do business with, someone who's decent and trustworthy or someone who's not?

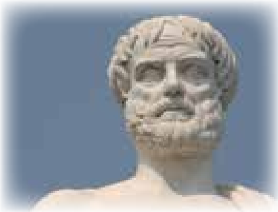
The question now becomes: *how* might an ethical approach be developed in banking?

Developing an Ethical Approach

Who should take the lead in developing an ethical approach for the global banking industry? Academia can help, but it's likely to be a supporting role.

As John Boatright observes in *Finance Ethics*, finance scholars are constrained by a research paradigm that excludes normative – ethical – questions, and demands the use of particular methodologies and analytical tools. Consequently, finance scholars inhabit a realm with internal conceptual consistency but limited substantive engagement with the complexity of the outside world. Ethical issues, perhaps considered too touchy-feely, cannot be adequately explored in such a space.

The field of business ethics, meanwhile, has grown significantly in recent decades. Yet business ethicists have focused on other issues and published relatively little on finance-related topics. Perhaps they feel that finance, as a set of



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practices or as a body of theory, is overly technical or demanding, even if they now realize how important it is. Where they have examined financial topics, they (myself included) have tended to focus more on the margin rather than the mainstream by highlighting topics like socially responsible investment, microfinance, green banks and Islamic banking, as opposed to conventional banking operations. Marginal banking innovations are important, but the scale of their operations is a drop in the ocean compared with mainstream banking.

In short, financial experts don't dwell in the space of ethics, and ethicists eschew the domain of finance, leaving the intersection of banking and ethics a largely barren landscape. As a result, the academic community was not standing ready with advice and insights when the global financial crisis struck.

This is still the case today. There's more interest and activity than there was before, but it's a cottage industry. The banking sector will have to make much of the running itself. But at least this means any solutions are likely to be grounded in the realities of banking practice.

Creating a More Compelling Purpose

Not long after the global financial crisis struck, I was part of a meeting of regulators, senior banking figures and academics convened to discuss what had happened and how to respond. At one point I asked those present, "What is the purpose of banking?" Not surprisingly, they didn't refer to the creation of shareholder value (much of which had recently disappeared anyway). After a little thought, they came up with "financial intermediation," in particular taking small, short-term deposits to create larger, longer term loans for those parts of the economy that can use the savings productively. So far, so good: a sound, traditional view.

Tellingly, my fellow participants confessed that they failed to see the point of some of the sophisticated financial innovations that had helped get the banks into so much trouble.

Since then, it has been interesting to see how individual banks have tried to create a more compelling sense of purpose. Done well, such narratives can be used to set the tone for the bank's ethos and guide its policies and practices. As an example, Lloyds Banking Group lists three principles in its purpose and vision statement: putting customers first; keeping it simple; and making a difference together.

It's easy to be skeptical about such statements, but they can be a useful way of turning attention to important matters. How can we add some flesh to such bare bones, though?

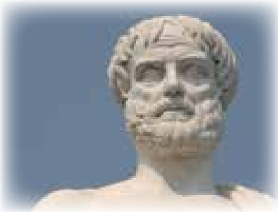
One way hinted at by Lloyds' reference to customers is to think about stakeholders and how a bank should treat them. In business schools, we usually advise students to develop specific lists of stakeholders for each particular organization. In the case of a typical bank, the list might look something like this:

CUSTOMERS. Going back to Lloyds' tenet of putting customers first, I would start with separating customers into different groups, since customers come in different forms. How do you treat depositors? How do you treat borrowers? And how do you treat purchasers of other financial products or services?

- **Depositors.** In the case of depositors, bankers have to gain and retain their trust,

ABOUT THE AUTHOR

Christopher Cowton is an internationally recognized scholar in business and financial ethics. The author of more than 60 journal articles and numerous book chapters, he served as the editor of *Business Ethics: A European Review* for a decade and is currently a trustee of the London-based Institute of Business Ethics. He is Professor of Financial Ethics at the University of Huddersfield in the U.K., where he was Professor of Accounting (1996-2016) and Dean of the Business School (2008-2016).



A bank might ask: what do we do that makes us worthy of trust and what do we do that undermines it? In particular, are our behavior and communications well aligned?

so *trustworthiness* is important to think about. As BNY Mellon Chairman Michael Cole-Fontayn observed in 2008: "The Lehman Brothers collapse made financial institutions realize that the most precious thing they are entrusted with is trust – and that winning that back was going to take both structural and cultural change that would have been unimaginable just a few years before." So a bank might ask: what do we do that makes us worthy of trust and what do we do that undermines it? In particular, are our behavior and communications well aligned?

- **Borrowers.** What about borrowers? What are their main issues? A classic concern, going back to biblical times, regards interest rates. In today's market, there are credit cards and payday loans that charge astronomical interest rates. Also, how do you avoid lending borrowers too much? What happens if they get in trouble and can't meet payment deadlines? What if they can't repay at all? In my view, virtues like *fairness* and *responsibility* address these situations.
- **Purchasers of Financial Products.** *Fairness* is again important in the case of purchasers of financial products. A common criticism that emerged from the financial downturn was the unfair selling of complex, technical products by many institutions, where the line between financial adviser and retailer was tremendously blurred. Perhaps clients should have sought proper advice, but there's no denying that some banks didn't behave well toward their customers, exploiting their vulnerabilities.

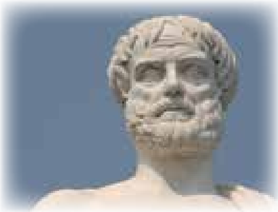
EMPLOYEES. Again, banks should treat this important stakeholder group with *fairness*. Employees who are members of professional bodies are a particularly interesting subgroup. Accountants, for instance, are supposed to adhere to certain ethical standards, yet employers might provoke organizational/professional conflict by trying to force them to march to a different beat. Bankers need to be *respectful* of their professional colleagues and the standards that they bring, or should bring, to the business.

SHAREHOLDERS. Shareholders didn't fare well in the global financial crisis, unless they sold their assets ahead of the crash. Recklessness and herd behavior on behalf of financial agents were prime culprits – attitudes that rippled across the management hierarchy in some firms. In this case, virtues like *prudence* and *transparency* are important.

However, exercising virtue is easier said than done in some cases, as IESE's Antonio Argandoña noted in "The Financial Crisis: A Search for Ethical Criteria." He wrote: "Prudence, or practical rationality, is the main virtue of bankers and business leaders in general, but it is difficult to exercise it in an environment of high growth, low interest rates and extraordinary opportunities for profit."

REGULATORS. Bankers might not support everything regulators do, but I would suggest that they should be *straightforward* in their dealings with them as society's representatives.

I would encourage all banks to go through such an exercise, building on these initial ideas. In thinking about a bank and how it should deal with its stakeholders, notice that I have begun to use words like *trustworthiness, fairness, responsibility, respectfulness, prudence, transparency* and *straightforwardness*. This is deliberate and reflects a turn in moral philosophy back toward the ancient tradition of virtue ethics, associated with thinkers such as Aristotle and Thomas Aquinas. Although such language can be applied to organizations, as I have just done, virtue ethics traditionally relates to individuals. Can we push forward our ethical agenda by thinking about the virtuous individual banker then?



Defining the Virtuous Banker

What might a virtuous banker look like? Where might we look for inspiration and guidance in answering such a question?

A little while ago, I asked a similar question about accountants. In coming up with an answer, a couple of things were in the back of my mind.

First, although I have huge respect for philosophical reasoning, I also have a great deal of respect for professionals seeking to do business in the complexity of the real world. I therefore didn't want to take abstract, theoretical concepts and terms and seek to impose them. Instead, I wanted to answer the question using language that accountants would, or should, be familiar with. I was seeking to ground my philosophically informed analysis in their world.

Second, I was conscious that accountants are involved in many different roles in all sorts of organizations; yet I wanted something that could reasonably apply to all of them.

I found my foundation in the code of ethics of the International Ethics Standards Board for Accountants (IESBA). This has been adopted by many professional associations around the world. The code contains five fundamental principles, from which I attempted to infer a set of virtues. That might have been difficult.

EXHIBIT 1

The Virtuous Accountant: A First Approximation

USING THE IESBA PRINCIPLES, I INFERRED A SET OF CORRESPONDING VIRTUES.

FUNDAMENTAL PRINCIPLE	ASSOCIATED VIRTUES
1. Integrity	• Straightforwardness • Honesty • Truthfulness
2. Objectivity	• Objectivity • Skepticism • Independence
3. Professional Competence & Due Care	• Competence • Diligence
4. Confidentiality	• Discretion
5. Professional Behavior	• Uprightness

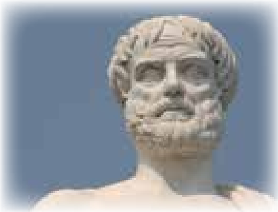
For example, when the code uses the term *integrity*, it doesn't do so in a way that corresponds closely to the philosophical literature or even everyday usage. This becomes clear when you read the code's commentary; yet reading that commentary meant that I could understand what accountants mean by integrity and derive from it certain virtues, keeping close to the code's own language. I proceeded by picking out terms that looked like, or pointed toward, virtues. The full version of my first approximation of the virtuous accountant is shown in **Exhibit 1**.

This is merely illustrative, but it raises three important considerations when formulating a framework for the virtuous banker.

- First, it applies to many types of accountants, even though different roles might call for different weightings and perhaps additional virtues.
- Second, the analysis is grounded in the profession's own language, with minimal imposition of foreign academic terminology.
- Third, although it is based on an ethics code, the analysis includes issues related to competence, which relates to what ethicist Boudewijn de Bruin describes as "epistemic virtues" in his book *Ethics and the Global Financial Crisis: Why Incompetence Is Worse Than Greed*. This combination of competence and ethics is a common theme in sociological accounts of what it means to be a professional. I suggest that any list of characteristics of the virtuous banker should include elements of both ethics and competence. Indeed, the word used by Aristotle, *areté*, can be translated more broadly as *excellence*, which is more than just moral virtue. A further connection, I would add, is that professionals have a moral obligation to be competent.

To answer our question about the virtuous banker, what would be wonderful would be an international resource, similar to the IESBA code, to draw on for bankers. Unfortunately, to my knowledge, no such resource exists. Perhaps that should be on someone's agenda, if it isn't already.

An alternative would be for an individual bank to think about what virtues, or elements of character, it would like to see in its staff, particularly senior bankers. These characteristics should align with things like the bank's



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statement of mission, vision and values, and an understanding of its culture at its best. Some possible candidate words have already been indicated in the consideration of a typical bank's stakeholders. Such a banker profile could be seen as the personification of what the bank aspires to be like.

In the meantime, individual bankers can reflect on what they want to be like. A good starting point might be the cardinal virtues of *prudence, temperance, fortitude* and *justice*, though it would be necessary to think through what these mean in a professional context.

Alternatively, or additionally, the first approximation of the virtuous accountant in the earlier table could be studied as a point of departure; not that bankers are the same as accountants, but they are similar enough for the list in the table to prompt some fertile thinking. And, as previously indicated, the general statements of the banker's employer should be capable of providing food for thought.

Nevertheless, in a sense the issue is not the list itself. As long as it is a reasonably sensible, plausible list, it is likely to be of some value. The key things are the thought that goes into it and the understanding and behaviors that flow from it. Just as a code of ethics needs to be more than just a corporate policy statement, so the description of the virtuous banker needs to be more than just a list written on a piece of paper.

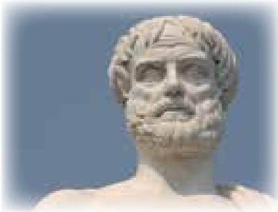
Christopher Cowton (right) addressed ethics in finance during a 25th anniversary CIF event at IESE Madrid moderated by Joan Fontrodona (left) and Antonio Argandoña

The Benefits of a Virtue Approach

As I mentioned earlier, virtue theory has seen a resurgence in moral philosophy. In itself, though, that is probably of little concern to banks and bankers. However, in everyday life, including everyday business life, people often frame their views in terms of moral virtue. Tom Whetstone, a student of mine at Oxford, was one of the first doctoral researchers to examine virtue in business ethics. He was interested in ethics and virtue, but he didn't want to ask leading questions, so when conducting fieldwork in a U.S. supermarket, he would ask employees, "Who do you consider a good manager around here?" *Good* is a usefully ambiguous word in such a context.

Interestingly, the people the employees admired were not necessarily those who achieved the best results, but those who both did a good job and were fair and supportive of their staff. Moreover, their heroes were frequently their first supervisor, not the chief executive, which is very telling. It was someone they saw consistently putting virtues into practice every day.

Building on this, I would suggest that, in the banking sector, a virtue framework can be beneficial in several ways. For example, in



reflection and self-development, bankers might ask themselves about virtue *x*:

- Am I *x*?
- When am I at risk of being not-*x*?
- Have I been not-*x* recently? If so, why? What happened?
- How can I become more *x*?
- Do I know someone I admire for being *x*? How could I be more like them?

Similarly, a list of virtues might be used in recruitment and selection, or to help frame a staff development agenda. A consideration of virtues might also lead to questions of relevance to culture. After all, a *good bank* and a *good banker* should be a good fit. Consider these questions:

- Do our remuneration and promotion systems reward or punish the virtues we want to instill?
- Do our top managers emulate the virtues that we claim to uphold (the so-called tone from/at the top)?
- Do we celebrate cases where valued virtues come through strongly?

We often talk about banks and other businesses creating or destroying value. Perhaps we should also ask: (how) do we create or destroy virtue?

Financial Ethics: Moving Forward

The health of the banking system matters. There's plenty of work for regulators, directors and banks to do in terms of formal regulations, processes and procedures. But many analyses of the financial crisis suggest that at least part of the problem was ethical in nature, which leads us toward a consideration of culture and character.

The great advantage of a virtue approach is that it personalizes things and turns abstract principles – whether philosophical ethics or bank policies – into something tangible to which people can relate. It also means that any banker can get started in thinking ethically about their work, without the need for system-wide progress – though that would help.

Financial ethics isn't just about virtue, though, and there is a massive amount of thinking and development to be done. As an academic body of knowledge, financial ethics is still in its infancy and will likely remain so for a long time. Resources are lacking and I'm not convinced that the academic community is up to the job – certainly not on its own. The insights, resources and energy of bankers are needed.

So, what should bankers do as they wait for the global industry to devise a comprehensive ethics framework of which the notion of the virtuous banker would be part, or from which it could be derived?

In my view, bankers need to reflect on their core activity and ask themselves questions like:

- What does my job look like and what does it mean to do it well?
- What kind of banker do I aspire to be?
- Who do I admire and why? How can I become more like them?

Moral virtues will be part of this, but so will competence – which a banker has a *moral* responsibility to possess, I would argue.

Bankers have not enjoyed much respect of late, but it is a perfectly honorable occupation – or can be. If enough bankers are virtuous, that should be good for all of us. And perhaps it will even reduce the chance of another major financial crisis. ☐

TO KNOW MORE

- Christopher Cowton gave the opening address "Ethics in Finance: Banking on Virtue?" at an expert panel moderated by IESE professors Antonio Argandoña and Joan Fontrodona to celebrate the 25th anniversary of the Center for International Finance (CIF) at IESE Madrid in June 2018. Read "Deconstructing the Pillars of Finance" about the work of CIF at www.iese.edu/news.

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