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# **A Short Guide to Ethical Risk**

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**GOWER**

# **5** Areas on Which to Focus Efforts

## **5.1 EXTERNAL AND INTERNAL MEASURES**

In relation to the tools that can be used to mitigate the risk of unethical actions, the following classification can be used: external measures – externally imposed onto individuals without them participating in their definition – and internal measures, with individuals actively participating in their definition. Let's analyse them in greater detail.

### **EXTERNAL MEASURES**

Local, national or supranational laws and regulations, as well as specific organisation policies and procedures are all external measures. The advantages of this type of measure come from the fact that rules are formalised in writing, communicated through official channels and, therefore, most probably known by everyone who is asked to observe them. This leads to clarity when interpreting them as well as consistent behaviour, with all its subsequent advantages. The use of rules, in fact, makes it easy to identify a lack of compliance. Furthermore, applying repressive measures is feasible. Therefore, they play an

important role in discouraging people who might be tempted to adopt unethical behaviour. In fact, because they perceive a real risk of being found out and facing disciplinary measures, they would find it hard to “rationalise” their behaviour and, most probably, would not adopt it.

There is a significant limitation ingrained in “external” remedies; laws and rules are often perceived as impositions and do not affect the nature and conscience of an individual. Consequently, individuals comply with the rules because they are forced to and rarely because they perceive them to be fair and necessary. In reality rules are adhered to only in proportion to the perception of the risk of being found out to be not in compliance with them and, eventually, sanctioned. If this risk is relatively low, or if the specific behaviour is not defined by a formal rule, then the individual will tend to “rationalise” unethical behaviour easily and, consequently, have no qualms about committing the crime.

## INTERNAL MEASURES

Internal measures directly appeal to an individual’s moral conscience which is linked closely to their personality and upbringing. These are measures that, unlike the external ones, are genuinely connected with the notion of ethics and are not dependent on the existence and application of laws and rules. (Incidentally, laws and rules might not even be inspired by ethical principles, an example being the anti-semitic laws of Nazi Germany or those on birth control in China.) The purpose is not to have a more ethical business world through the mushrooming of careful laws, but rather to promote and encourage the development of a moral conscience among individuals belonging to this world. By doing this, ethical principles will be applied on the basis of values that have been

processed and interiorised by the individuals themselves and irrespective of the existence and content of any law.

The adoption of internal measures only would entail the lack of a frame of reference which individuals can turn to whenever they have to make ethically challenging decisions. In fact, ethical people end up making decisions that turn out to be ethically undesirable for the system as a whole because they are not fully aware of the consequences of their decisions or because they are not knowledgeable enough to judge them in a more general, and often complex, context. The recommendation is to adopt both internal and external measures simultaneously to achieve long-lasting results. Modern capitalism is betting on the realisation of the importance of this apparently trivial observation and on the efforts it needs to make to identify, for each type of measure, the initiatives that can lead to tangible results.

The following chapter will outline internal measures made popular by the school of thought which demands more ethical and responsible conduct from businesses and which has developed over the last few decades. No specific reference to external measures will be made because a discussion on laws and regulations is too technical for the purposes of this guide.

## **5.2 SPREADING A COMPANY CULTURE**

Company culture encompasses all the unwritten rules, values, customs and styles which influence the expectations, thoughts and behaviour of people who operate within its organised structure. As such, a company culture is unique and cannot be replicated because it is a function of the people who

work within the organisation. Its main components are the company's philosophy and management style.

## COMPANY PHILOSOPHY

Over time, each organisation defines the values that meet with the approval of both top management and the rest of the employees and are shared and spontaneously applied by every member of staff. All these values make up the company philosophy. As it is the outcome of the interaction of the personalities of all members of the organisation, in defining them, management's charisma and leadership qualities play a fundamental role. Consider, for instance, how much these characteristics have influenced the development and definition of the company culture of what is now the most respected and admired consultancy firm in the world: McKinsey. In the 1930s, Marvin Bower, a young American lawyer, understood the enormous potential of what we now would call management consulting and began to work for McKinsey & Co, a small Chicago-based consultancy. In just a few years, he was able to transform the company into the best consultancy firm in the world and a true point of reference for the entire sector.

Bower believed that the philosophy and culture of a company had to develop naturally and almost through a trial-and-error process that improves over time. Every employee has to share these values, not because they are imposed but because they share their fairness and ethical basis and, consequently, they must be at ease when they apply them daily. In this sense, according to Bower, their formal definition through, for instance, a code of conduct, was unnecessary. The values expressed through the management's leadership and charisma were therefore conveyed to the rest of the organisation through

a totally informal and natural process enabling them to be really absorbed and, consequently, practised. Obviously, for the process to yield the required results, it was fundamental to select the right people not only in terms of skills but also personality and moral values at every hierarchical level. McKinsey's company philosophy, as a set of values truly recognised and lived by all the employees, has become a point of reference for many other companies.

Bower attached great importance to the ethical aspect of the activities of the company he was managing and maintained that this was necessary to achieve the highest success for at least three reasons:

1. When there are well-defined ethical principles, people are more determined and efficient; there are no doubts and no time is wasted in considering possible alternatives;
2. A company practising recognised moral principles inevitably attracts high quality applicants, making the recruitment process much easier.
3. A company practising recognised moral principles establishes better and more solid relationships with its customers, competitors and the general public; everybody is aware that the company will do the right thing at the right time.<sup>1</sup>

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<sup>1</sup> From *The Will To Manage: Corporate Success Through Programmed Management*, Marvin Bower, McGraw-Hill, 1966.

## MANAGEMENT STYLE

Over the last few years, in the field of internal audit and in other disciplines dealing with the ethical aspect of a company, the expression “tone at the top” has been coined to define the fundamental influence that top management has on the rest of the organisation. This influence strongly contributes to defining the company culture.

The management style of an organisation is determined by the following two components:

1. The degree of transparency of top managers’ activities in relation to the company or Group shareholders.
2. The degree to which top management shares decisions with the different hierarchical levels. When there is real management sharing, top managers and all the other levels below them contribute to defining company policies and making decisions.<sup>2</sup>

According to the level and mix of these two components, management style fluctuates from participatory, when they are both present to the highest degree, to authoritarian.

A participatory management style, which attaches importance to communication between the various company levels, creates, under the same conditions, greater transparency and auditability of management’s work both by management itself (a natural form of cross checks comes into being) and by independent functions, such as internal audit. This, therefore,

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<sup>2</sup> See *Frodi societarie e corporate governance* (Company Fraud and Corporate Governance), Chapter 3.5 “Area critica: stile di direzione” (A Critical Area: Management Style), Giorgio Lagana’, Il Sole 24 Ore 2004.

will be the model of management style that an ethical company will want to adopt.

There are many types of negative behaviour that management adopts that exert a strong influence on the style which will characterise it in the eyes of the employees. The following are some of the more popular examples of this behaviour. Management:

- Communicates untrue results on company management to employees, shareholders and the public;
- Does not comply with accounting standards in order to pocket higher bonuses;
- Abuses company perks;
- Does not state a conflict of interest with the company;
- Does not comply with the code of ethics and company policies and procedures;
- Avoids internal controls for direct or indirect personal gain or to commit fraud;
- Does not take responsibility for decisions taken that are relevant to its sphere of competence;
- Uses company assets for personal purposes;
- Uses its position to control and manipulate employees;

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- Uses working relationships (with suppliers, for instance) to obtain personal advantages.

Unless top management acts as a positive role model for employees, showing how to behave, the entire organisation will believe, at a subconscious level too, that the above behaviour is not important and that, therefore, everybody can adopt it. Experts in company fraud, for instance, highlight the fact that companies without an adequate tone at the top are more easily victims of fraud compared to those where management has adopted a style that is consistent with the moral values expressed by the company's code of ethics.

In reality, companies often convey conflicting messages to their employees: the company must act according to pre-set and formally communicated principles but management is the first to show that it does not believe in those principles and the way it acts is not consistent with them. As has already been seen, this message can be the outcome of the adoption of decidedly unethical conduct. The same undesirable result can be obtained by making decisions that are not necessarily unethical per se. In fact, by conveying a message inconsistent with the principles laid down in the code of ethics or, in any case, the best practice applied by most companies, this conduct is perceived by the employees as a serious lack of professionalism on the part of management and leads to a sudden loss of trust.

The following are some examples of the most frequent contradictions found in bodies that are responsible for ensuring ethics in a company: the internal audit and the compliance functions. Management:

- Does not create internal audit and compliance functions with clear responsibilities for identifying and pursuing breaches of ethical principles;
- Does not assign to these functions adequate decision-making powers to fulfil their responsibilities effectively;
- Does not ensure for them the necessary independence in terms of hierarchical lines;
- Does not adopt an accurate management information system when the problems highlighted by these two departments need to be urgently communicated and solved (“escalation process”);
- Does not assign adequate resources to the compliance function to provide employees with the necessary training on the code of conduct.

### **5.3 THE EFFECTIVENESS OF CORPORATE GOVERNANCE MODELS**

Opportunity within a company is also heavily influenced by its model of corporate governance. Even though several definitions of corporate governance have been formulated over time, a comprehensive one sees corporate governance as the structure through which the objectives of the company are set, and the means of attaining the objectives and monitoring performance are determined.

Once clarified what corporate governance is, it is pivotal to explain what good corporate governance means. The Financial Reporting Council, the UK’s independent regulator, has set

out the following definition in the Combined Code, i.e., the code of corporate governance:

*Good corporate governance should contribute to better company performance by helping the board discharge its duties in the best interest of shareholders; if it is ignored, the consequence may well be vulnerability or poor performance. Good corporate governance should facilitate efficient, effective and entrepreneurial management so that can deliver shareholder value over the longer term.<sup>3</sup>*

The following are examples of conditions that a good corporate governance model must meet:

- The creation of management and control committees and bodies, and establishment of a system of regular meetings to ensure efficient and effective management through sharing high-level information and a transparent decision-making process;
- The assignment of specific responsibilities to the different company roles and the definition of clear reporting lines;
- The creation of independent bodies to control company management and compliance with laws;
- The adoption of rules preventing conflicts of interest;
- The implementation of an efficient internal control system; and

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<sup>3</sup> The Financial Reporting Council (FRC), the Combined Code, June 2008.

- The impartial selection of the external auditing company to be responsible for the certification of the balance sheet;
- In the case of a Group, its legal structure should be consistent with its business activities and should not be artificially complicated by creating, for instance, several holdings.

Since a company's circumstances vary over time, its corporate governance model has to evolve in line with this and must be reviewed continuously for it to remain effective. This implies that there is no single standard model but there must be processes to oversee its suitability over time in relation to, for instance, any regulations that define its requirements, functions and effectiveness.

The concept of corporate governance is rather complex in that it includes a series of components and aspects which, from time to time, take on different importance in creating an "opportunity", as defined in fraud theory and, therefore, turn out to be more or less risky. The following is a short illustration of what are usually considered to be the main components of the corporate governance of an organisation.

#### MISSION, VISION AND STRATEGY

The mission defined by every organisation identifies the fundamental purpose at the very basis of its creation. In practice, it summarises in a sentence the organisation's *raison d'être*. In the case of a car company, for instance, its mission could be: "To create cars for which our customers perceive an added value". Rather than the mission, some organisations prefer to define the main values with which the company

identifies and which inspire its choices and priorities. British Petroleum, for instance, one of the largest oil and energy companies, in its value statement states that:

*BP wants to be recognised as a great company – competitively successful and a force for progress. We have a fundamental belief that we can make a difference in the world. We help the world meet its growing need for heat, light and mobility. We strive to do that by producing energy that is affordable, secure and doesn't damage the environment.*<sup>4</sup>

Like its mission, every organisation defines, more or less formally, its vision, that is to say the future, projected and desired state of the organisation in terms of its long-term objectives and strategic direction. In the case of a car manufacturer, an example of its vision could be: “To become one of the three market leaders in the manufacture and distribution of medium sized cars” or “To become the leading car company in the production of low pollution engines”.

The company strategy is a plan defining the allocation of human and financial resources to achieve the objectives of the company. The strategy is a fundamental document to manage the company itself and ensure that objectives are actually achieved.

Vision, mission and strategy are three fundamental components of corporate governance, since they define the nature and purpose of the organisation and dictate the direction that the company must follow during its development and consolidation. In this sense, they are essential elements to

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4 From British Petroleum's Value Statement, [www.bp.com](http://www.bp.com).

assess the ethical aspect of an organisation. For example, the definition of the nature of the activities performed by a company is fundamental to understand the ethics inherent in its business. Those who believe that arms production is unethical would probably not invest in or do business with a company whose vision is “to become the largest manufacturer of fighter jets and missile systems”. They would also hesitate to deal with a company whose description of its activities in its vision is not in line with its actual activities. Even though it stated that it was an energy company, in the 1990s, i.e., at the height of its fraudulent activities, Enron, the American energy giant, was acting as if it were a financial company becoming involved in risky financial trading operations and paying bribes to politicians in various countries.

## ORGANISATION CHART

The basic document used to define responsibilities and hierarchical lines within a company is its organisation chart. It is used to understand who manages the company, what the operational and support departments are, and the way in which each of them relates to the others in terms of reporting lines. An organisation chart is usually visually represented to enable an immediate understanding of the company structure. Its analysis shows if the type of company structure is strongly hierarchical or more participatory. If the former has been chosen, the chart will be markedly pyramidal, with few departments at the bottom but many hierarchical levels. In the second scenario, the reverse will be true and the chart will be more horizontal. As previously mentioned, a participatory management style is reflected in a rather “flat” structure and, because it means greater involvement in company decisions by the various hierarchical levels, it facilitates the adoption of more ethical conduct.

## JOB DESCRIPTIONS

A job description is a document describing the role played by each individual within a company, his hierarchical position within his department and his reporting lines.

In terms of reporting lines, if the organisation chart highlights the relationships between the various company functions and the committees that have to manage the organisation, a job description is a document defining in greater detail who the individual employee reports to within the function to which he belongs.

With regard to decision-making powers, as established by the hierarchical position, qualifications and responsibilities, the job description has a dual purpose:

1. Assigning decision-making powers to individuals who have the necessary competences to exercise them;
2. Assigning accountability in relation to the decision-making powers.

The organisation chart, together with the job descriptions, describes the entire company's structure. When drawing them up, special attention needs to be paid to the following aspects:

1. They have to be clear and transparent so that everyone knows their own duties and responsibilities as well as those of other individuals and bodies contributing to the management of the company;

2. They have to be communicated and shared, i.e., everyone must be aware of and accept them;
3. They should not have any “gaps”, i.e., areas of responsibility not assigned to specific functions and/or individuals;
4. They should be balanced, i.e., they should avoid situations for which a decision-making power is not matched by a responsibility and vice versa.

Balancing powers and responsibilities is a fundamental aspect because it ensures that whoever had to make a decision actually took it; if this were not the case, he would have to justify this. Similarly, anyone who has made a decision will no longer be able to shirk his responsibility. The more confused the power/responsibility relationship, the more the excuses presented by people who should have not only managed effectively the company, but also ensure its ethical conduct.

## COMMITTEES

Many company decisions, particularly those of a strategic nature, are made by committees, i.e., a group of individuals who, after studying the details of a problem, vote in order to take a joint decision on it.

As in the case of individual employees, the problem relating to the balance between decision-making power and responsibility holds true for committees as well. In this case, the committee's competences and all the rules governing its operation should be formally defined in a document: the Charter. The Charter will include the following: name of the committee, areas of responsibility, chairman and secretary, members, frequency of

meetings, how decisions are made and relationships with any other committee.

A fundamental aspect to ascertain the proper operation of a committee is to check that the subjects it deals with and on which it makes decisions are written down in the minutes of its meetings and that these minutes are promptly circulated to the members for their comments and approval. The minutes will have to be drawn up as if they were an action plan in order to solve the problems that have been discussed. They will have to be updated at the following meeting by including the progress made on previously discussed matters. A similar system ensures that all the issues a committee is responsible for and that are raised by the various departments and employees are discussed during the committee meetings and effectively solved over time.

## SUPERVISORY AND MONITORING BODIES

A further fundamental component of corporate governance is the bodies in charge of monitoring and supervising company management. The ones that are most concerned with ethics within the company are the Audit Committee (and the auditing department that usually reports to this Committee) and the Compliance and Ethics department. Both are described in greater detail in the next chapter.

## INTERNAL CONTROL SYSTEM

Internal controls are structures, activities, processes and systems to help management mitigate the risks of not attaining company objectives. In this sense, a system of internal controls is also pivotal in supporting management in complying with their company's ethical standards generally expressed in a

code of conduct approved by the Board. Internal controls, for example, help in identifying cases of non-compliance with laws, regulations and policies or detecting cases of fraud.

## RISK MANAGEMENT

Risk management is a process aiming at identifying all company risks and, therefore, it involves an entire organisation. In establishing such a process, management want to identify the risks that could prevent the company from achieving its objectives. Their identification, in fact, enables management to adopt action plans to mitigate the likelihood of risks arising or, at any rate, their business impact.

Nowadays, large organisations create specific functions whose responsibility is to implement risk management processes and monitor risk levels over time. One of the outcomes of risk management is ethical risk (see Chapter 6, Section 6.4: Risk Management Function).

## 5.4 THE STUDY OF ETHICS

The study of ethics is one of the issues in the field of ethics on which economists and scholars have expressed rather contrasting opinions over the centuries. The 2004 article by John Hooker, Professor of Ethics and Social Responsibility at the Carnegie Mellon University in the USA entitled “The Case Against Ethics Education: A Study in Bad Arguments”<sup>5</sup> is a summary of arguments against the study of ethics. In this article he refutes the validity of these arguments one by one.

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5 “The Case Against Ethics Education: A Study in Bad Arguments”, an article by John Hooker, *Journal of Business Ethics Education*, 2004.

1. "The task of managers who run companies is to maximise profits for shareholders". This is called the Milton Friedman argument because he was the first one to suggest it. In practice, he maintained that the only objective of those who manage a company on behalf of shareholders is that of maximising profits. Managers, therefore, are neither qualified nor entitled to implement social policies unless they are a means to maximise company profits. Hooker specifies that managers are not asked to implement social policies but to deal with the impact that their organisation has on civil society and the environment. In relation to being entitled to do so or not, Hooker presents a simile. As in the case of a company directly run by its owner, who takes on the social responsibilities inherent in the business of the company, similarly, if the owner were to entrust the management of his company to an agent, this would logically have to fulfil the same social responsibilities. Stating the opposite would be like saying that a mafia man is not responsible for the murder committed by his henchman.
2. "Ethics in itself is not an incentive to apply it; financial (gains) or legal incentives (savings from avoiding fines or penalties) are needed". Hooker points out that incentives are necessary but not sufficient to create an ethical system. Thinking that the economic system can base its own ethics just on incentives is utopian because it is tantamount to saying that it is sufficient to pass a law for this to be automatically observed by everyone. The reality is quite different because, for instance, there are no adequate mechanisms to verify compliance with the law and few monitoring and law enforcement bodies which, sometimes, are even corrupt.

3. "Ethics is an innate quality of an individual that does not entail intellectual activity and is the not the result of reasoning". Consequently, it cannot be learnt. Hooker responds to this argument by pointing out how, in the course of history, the greatest "intellectuals" have discussed ethics and contributed to its development. He also recommends attending a class in ethics to realise what it means to deal with ethics in practice by, for instance, analysing real moral dilemmas.
4. "Ethics is learned by the individual only as an adolescent and, therefore, by the time he goes to university, it is too late to learn it". Hooker points out that, even though an individual's personality can be shaped already when he goes to university, the study of ethics aims at changing behaviour rather than personality. In this sense, learning the conceptual infrastructure on which to base one's thinking, learning the various advanced theories over time, analysing how real ethical dilemmas have been dealt with and resolved, distinguishing between the various possible ways of thinking and avoiding mistakes that are usually made, help individuals to think in terms of ethics. Hooker adds another particularly important motivation. Referring to the most recent developments in the field of psychology, he questions the fact that only during adolescence is personality fully formed. Various studies show that the evolution of personality goes through various stages, some of which occur during adulthood. In this sense, the study of ethics could also have an important influence on personality as well as on behaviour.
5. "There is no motivational incentive to learn ethics and, therefore, teaching it is useless". Many students are not really interested in courses on ethics because, in their

opinion, there is no reason to do so as it will not help further their career. Some teachers try to get round this lack of motivation by teaching the vision where profits can be maximised through ethics too. This is quite a popular vision and it is one that often leads companies to launch and finance humanitarian projects of various natures. However, the rationale at the basis of these projects can hardly be considered ethical because it is purely based on financial returns. Hooker moves away from this notion and, starting from the assumption that we are all interested in doing some “good”, tries to convince his students that one’s own social responsibilities can also be fulfilled by making profit.

## **5.5 SELECTING, ATTRACTING AND RETAINING “ETHICAL” STAFF**

Selecting those people who, from a moral point of view, are more valid will be increasingly important in the future for two reasons:

1. To lower company exposure to risks, such as fraud and reputational risks;
2. To create a working environment that attracts and retains individuals who are more in tune with the ethical culture of the company.

### **STAFF SELECTION THAT IS MORE FOCUSED ON THE ETHICAL ASPECT**

At the base of economic transactions there are values, such as trust in the other party, which are recognised in every

country to varying degrees. These values are reflected not only in the laws and regulations of individual countries but also in international or supranational laws and regulations. Usually, those who do not comply with them do not have access to the world of work. In fact, it is common practice, at the beginning of a career, to undertake a selection process where an individual who, for instance, has committed certain types of crimes is not accepted (at least not by the official world of work). Candidates are invariably requested to submit documents such as criminal records and references from previous employers when applying for jobs. Furthermore, respect for these principles has to be proven not only when the individual is first hired but also when he changes employers. Given the high level of flexibility in the modern world of work, this could in fact happen several times during one's career.

Therefore, working on the rules followed for selecting whoever enters the business world, particularly those who are chosen for positions carrying particular responsibilities within it, would seem a logical and necessary step to increase the ethical level in the business world. Current staff selection procedures ought to concentrate more on understanding a candidate's ethical measure, particularly their ability to distinguish morally acceptable conduct from conduct that is not, as well as their propensity to make decisions consistent with this criterion of discernment. It is now common practice to use questionnaires and interviews to assess the character and psychology of applicants whereas very little is still done to assess their ethicality. As early as the 1940s, Marvin Bower, founder of McKinsey, the most admired consultancy firm in the world, was attaching great importance to the selection of his staff, which aimed at assessing not only their technical skills but also the level of adherence to the moral principles at the very basis of McKinsey's philosophy.

Over the last few years, many researchers and experts have suggested that candidate intelligence ought to be evaluated on the basis of criteria that are different from Quantitative Intelligence (IQ), i.e., the intelligence enabling us to make rapid abstract links typical of mathematics.<sup>6</sup> In the 1990s Daniel Goleman, in particular, expounded the theory of emotional intelligence, based on those skills that in short enable an individual to relate to others and convince them to cooperate with him. More recently, the theory of emotional intelligence has been further developed giving rise to moral intelligence. In their book entitled *Moral Intelligence – Enhancing Business Performance and Leadership Success*,<sup>7</sup> Doug Lennick and Fred Kiel describe the outcome of their large-scale research work during which they interviewed a high number of chief executive officers in large companies to understand the distinguishing features that have led them to excel in the world of work. In particular, this is how they arrived at identifying moral intelligence as soon as they finished with their investigation:

*As we talked, we realized that we had some common ideas about the ingredients of high performance that we were both struggling to conceptualize. We agreed on the importance of emotional intelligence, the constellation of self-awareness, self-management, social awareness, and relationship management skills that are now commonly regarded as critical to success in the workplace (they were all highlighted by Daniel*

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6 Further reading: *Social Intelligence: the New Science of Success* by Karl Albrecht, *Emotional Intelligence, Why It Can Matter More Than IQ* by Daniel Goleman, and *Frames of Mind: the Theory of Multiple Intelligences* by Howard Gardner.

7 *Moral Intelligence – Enhancing Business Performance and Leadership Success* by Doug Lennick and Fred Kiel, Wharton School Publishing, 2008 edition.

*Goleman's work). We discovered, though, that neither of us thought emotional intelligence was sufficient to assure consistent, long-term performance... We hypothesized that there was something more basic than emotional intelligence skills, a kind of moral compass, that seemed to us to be at the heart of long-lasting business success. We decided to label this "something more" moral intelligence.*

Subsequently, they defined moral intelligence as the "mental ability to establish how universal moral principles must be applied to our values, objectives and actions". In other words, it is the capacity to differentiate between "right" and "wrong" according to universal ethical principles, that is to say, those relating to human behaviour and common to every culture.

## ATTRACTING AND MAINTAINING MORALLY VALID HUMAN RESOURCES

According to what the experts tell us, over the next few years, the main criteria for understanding candidates will be their alignment to the vision, objectives and culture of the company, aspects referring to the ethical element of the organisation.<sup>8</sup> Therefore, selecting people with an adequate ethical profile according to what has just been described is fundamental for creating a working environment that is perceived as ethical by future employees. Ultimately, companies that want to succeed will have to apply selection criteria focusing more on values and ethicality to ensure they hire personnel who stand out from a moral point of view too. In doing so, they create a suitable working environment to attract new resources with

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<sup>8</sup> "The War of Talent" published in *The McKinsey Quarterly*, No. 3, 1998.

a high ethical profile. This virtuous circle will ensure a strong company culture and highly motivated staff. In the long term, this process will generate a more robust organisation, able to adapt to change better and react to difficulties more quickly.

## 5.6 FAIRNESS OF INCENTIVE SYSTEMS

One of the few positive effects of the financial crisis of 2008 is that it brought to light the risk of inadequate incentive systems. In fact, for years in the banking sector, there has been an exponential growth in the remuneration of “bankers”, i.e., those executives and top managers working for investment or commercial banks. Usually, their remuneration is made up of a salary and a bonus. The second part of their remuneration is often extremely high and greatly exceeds that of similar professionals working in non-financial sectors.

In the autumn of 2008, following the beginning of the financial crisis, George Osborne, the British MP who was shadow Chancellor of the Exchequer, called for a change to bankers’ pay stating that *“The party is over for the banks. You can’t go on paying yourselves 20 times what a heart surgeon earns!”*<sup>9</sup>

The problem with incentives is that they are often linked to short-term profits rather than long-term ones. This fact pushes individuals to take on investments and business with risk profiles higher than the ones they would have normally considered reasonable. This leads to an illogical situation in which a professional earns enormous sums of money even when the company he works for has incurred losses or, as was the case for some companies during the financial crisis

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<sup>9</sup> From “Treasury’s Bank Bonus Team to Get Own Payout”, an article published in *The Times* on 9 February 2009.

of 2008, has been nationalised to avoid bankruptcy because it was considered “too large to fail”.

Recent events within the context of the financial crisis have further highlighted that this system entails three risks:

1. It is socially destabilising because the inequality that it creates between the various social and professional classes leads to worrying social tension.
2. It is economically destabilising because by promoting a short-term vision it makes the entire economic system unstable and puts it at constant risk of collapsing.
3. It is ethically destabilising because if the system collapses, those who pay for the consequences of this are taxpayers most of whom are not responsible for managing the system.

In October 2008, the Securities & Investment Institute (SII), the professional body for thousands of people who work in the securities and investment industry in the UK, issued a real policy to define fair and transparent bonuses. The purpose of this policy is to encourage its members and the general public to acknowledge the need to change the parameters that have been used so far to calculate bonuses in the financial sector.<sup>10</sup>

The following are the core principles outlined in this document:

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<sup>10</sup> The Bonus Policy issued by the Securities & Investment Institute in October 2008 can be downloaded from the Institute’s website: [www.sii.org.uk/web5/infopool.nsf/HTML/mIntegrityPosition-Paper](http://www.sii.org.uk/web5/infopool.nsf/HTML/mIntegrityPosition-Paper).

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1. Recognition and support of the concept of paying people an element of remuneration in recognition of achievements in their employment that are over and above what would normally be expected.
2. These achievements may not always result in additional income accruing to the firm because they could translate into greater savings or prevention of losses.
3. A bonus should take into account not only the contribution of an individual but also that of their team/division and the overall performance of the firm/company.
4. A bonus should also take into account factors other than profit, such as co-operation with others, compliance with procedures and training of others.
5. A bonus should reflect factors such as the risk that the company has taken on in doing a deal and the quantity of the firm's capital used. The amount of the bonus will be inversely proportional to these two parameters.
6. Payment of a bonus should not be front loaded and should be spread over a period relevant to the transaction e.g., between two and five years. This is to allow time for the results of the underlying transactions upon which the award was made to be properly evaluated.
7. Bonus awards should be indicative to allow the possibility of clawing back part or all of the bonus award should it emerge at a later stage that the underlying transaction was not as profitable as first thought. Similarly, the reverse could apply.

8. In the case of a quoted company, the higher the bonus award, the greater the proportion which should be paid in shares. This ensures that the objectives of the individual are aligned with the shareholders and encourages a long-term approach.
9. The larger an award compared with an employee's basic salary, the greater the need for it to be signed off by an independent body within the firm, such as the Remuneration Committee.
10. The annual accounts of firms should, in future, provide a level of disclosure above the statutory minimum on bonus payments. This way, transparency would increase.

In light of these considerations, bonuses, as an incentive system adopted by the financial sector, must be reviewed in order to have a greater degree of fairness within the general scheme of remuneration. Fortunately, some countries seem to have understood this lesson and have introduced some changes and have taken operational measures to solve this problem. International bodies such as the Financial Stability Forum (which, during the G20 summit held in London in April 2009, became the Financial Stability Board), which brings together Finance and Economic Ministers and central bankers of some of the countries belonging to the G20, and the European Commission, has recently set some guidelines that banks have to follow when defining remuneration systems for their employees. It has also introduced in its agenda further discussions on this issue to lay down more specific rules, in an attempt to create greater transparency in the remuneration of bankers and the results of the financial institutions they lead. The real challenge, however, lies in the harmonisation of these new rules because their effectiveness will be greater

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or lower according to the measures that other countries will adopt and implement. In fact, it is logical to assume that, if there are wide differences between what a banker can earn in one country as opposed to another, many of them will leave the country to move to more lucrative shores.