Dialogue II: Ethical Business Regulation

Summary of an event held under the Chatham House Rule on 19 September 2016 at St Paul's Chapter House

The overall objective of the Dialogues programme is to give senior City figures a safe place to talk where we can look at subjects from new perspectives. We hope that this will build interest and support both for the Institute and the wider life of the Cathedral.

The theme for this discussion – Ethical Business Regulation – arises because much of business suffers from a lack of trust as do many public institutions. A concept of fairness exists in us from childhood and respect for rules and systems is undermined when the rules are not enforced evenly and fairly. How can a sense of fairness and respect for one another, and for our customers, help restore a sense of social accountability and bring us to a mutual exchange through honest trade that improves the common good? Why do people obey rules or break rules? What are the different roles for incentives and punishment in a regulatory framework?

Understanding the way in which law and regulation interact with culture and ethics to generate behavioural outcomes is essential if we're going to understand the root causes of some current behaviours and how to change them.

Please read this as a summary of a wide-ranging discussion which tries to give the reader a sense of the conversation, rather than as a position on any of the issues.

A Behavioural Science Approach

- Behavioural research shows that people obey rules voluntarily in certain circumstances – family rules, club rules, social norms etc. – where the rule is made and applied fairly, and the substance of the rule is fair.
- There needs to be proportionality in response to transgressions. It is important to deal with past deeds and motivating future behaviour differently.
- It should be possible, using behavioural science, to build a system in which you have compliance and regulation.
- Enforcement based on deterrence and fear only works in rare circumstances.
- People won't volunteer information if they are afraid – if they think they are going to be embarrassed. The social element of compliance is often stronger than deterrence through fear of punishment.
- In the classic model, accountability is vertical through top down command and control. In the new way of thinking accountability is more horizontal, mostly because it is social. You can make a mistake, but the important thing is to own up to it straight away, so it can be put right. The information can then be fed back into the system – anonymised in certain circumstances – and the functioning of the system greatly benefits as a result. Aviation safety would not work without such an approach, which they call an open and just culture.
- There is a need for a different social model for business that includes fairness, openness, owning up, as well as saying or checking that we are doing the right thing. One, do the right thing. Second, speak up, ask, check. In other words, ask what the right thing is because we might not know. It is important to engage both fast brain and slow brain.
- Group behaviour is quite important and therefore strong leadership can sometimes be dangerous (i.e. bullies). Quite a lot of us conform without thinking about it, most of the time. This makes the group culture critical and the culture of saying 'is this right, should we check?'

- Most of our day-to-day decisions are not made by reference to rules and regulations, or to rational evaluation, but by gut feel that we then try to rationalise.

Ethics & Values

- People have not really looked at culture through the lens of ethics, perhaps because it is interpreted as being right and wrong; black and white; a little bit more constraining or a little bit more uncomfortable.
- According to the Christian narrative the primary problem about human behaviour is pride, which is the inability to be accountable to yourself. Before you are accountable to other people, you have to admit it to yourself. Various natural behavioural traits such as underestimating risk, and thinking you have all the information, can be seen through a 'pride' lens.
- There's a risk of instrumentalising ethics, or reducing ethics to a tool for achieving a particular business or regulatory end or purpose: that is likely to be self-defeating because the potency of ethics in a business context as elsewhere is derived from the fact that it directs us towards some greater or transcendent end, such as human good. An instrumentalised ethics is one which has been captured by a lesser end, such as maximising the commercial success of a company by avoiding behavioural risk. To determine how far we are using ethics as an instrument, we need to understand to what end or purpose the aspiration for more ethical behaviour is directed.
- Companies need to focus on building trust as an enabler of positive behaviours within the company and as a driver of business performance.
- The Church has a lot to talk about in terms of moral authority. We should consider how to use the Church as a voice of leadership in this issue.
- You can achieve much greater compliance with openness and forgiveness, which is very different than overlooking misbehaviour.
- In the many reports issued since the financial crisis, there is much talk of culture but little about a value system. Whether Christian values or ethical values or humanistic values – there is a value system that is actually missing.
- A particular challenge at the moment in the City is to do with remuneration. There is a firm perception that some people are overpaying themselves and it's sending the wrong messages about values. You are never going to get the right decisions made at the bottom of the pyramid if people are saying they don't trust the CEOs and executives, who are judged on their behaviour rather than what they say. In addition, the perception of compensation relative to the degree of responsibility matters, as does the differential in compensation between the top and bottom of an organisation.
- Integrity is highly rated in most of the reports on this subject, and often over honesty. What does integrity actually mean?
- It is vital to bring these values to life. Words on a piece of paper are only effective if you go down to the next level and say "what does that actually mean for the company, how does that translate into behaviours that we expect from our employees?"
- No blame is a specifically Christian approach and it works. You can demonstrate that it works despite it being counter intuitive for a lot of people. It is not common sense to a lot of people, which is why it is important for the Church to be talking about it.
- What's the right thing to do, what's the ethical thing to do? Talk about it! Have a conversation about it. Disagree, by all means. How can we best encourage and embed a culture of disagreeing well?

Purpose

- Is sufficient attention being given to the concept of purpose and its importance to both ethics and culture? Culture concerns the way in which we organise reality around our understanding of purpose – at what are the behaviours and what are the values directed?

- We need to be wary of the implicit assumption that business organisations at present are essentially neutral places to which ethics and culture need to be applied, or need not apply. They are not. Every organisation has an existing culture and an existing ethics. Each of them addresses some particular end or purpose. The question is: is that ethic, is that culture, is that purpose to which those are directed the right one, is it what is right for the company, its stakeholders and wider society?
- Economic, cultural, political and moral liberalism place emphasis on the individual's freedom of choice. Has this left us ill equipped to identify shared ethical coordinates and a shared purpose beyond the bottom line?
- Some think that changing our culture and changing our ethics will take a generation. Will it?
- The purpose of a company cannot be simply to maximise shareholder value. Rather shareholder value comes from a unique purpose in society and the economy and delivering well what is promised to all stakeholders.

Culture & Diversity

- Values, attitudes and behaviours are the things consistently mentioned as defining culture.
- The aviation industry is an excellent example of an open culture of compliance that encourages honesty, responsibility and accountability through people admitting to their mistakes – without fear of judgement – so that they can be fixed.
- Sharing information is critical to corporate culture and success.
- Understandings of what is meant by ethics and culture can be exceptionally thin. There is a risk that expressions like culture, ethics and integrity can give the impression of change when they have opposite effect and the underlying substance never really gets grappled with. Be careful of collective delusion and wishful thinking.
- There is often a commercial imperative to tackle culture, be it a crisis or existence within an industry where keeping pace what their customers want is key to market share. For example, if companies don't develop products that are environmentally friendly then they can very quickly start to lose market share. Focusing on culture makes good business sense.
- Being open and accountable are key features of healthy cultures; as well as demonstrating strong leadership and the need for leaders to really live what it is that they are telling their employees and customers about how they go about doing business.
- It is important to measure, monitor and engage about culture. If you don't know what culture you've got, it is impossible to oversee, intervene or change.
- Much of the data and information from which to gain cultural insights is already collected, but not necessarily presented or interrogated in a way that enables boards and leaders to use it effectively. Techniques exist to measure the culture/values of an organisation, but are not widely known. Big data permits companies to mine information and extract hidden messages from it in an accessible way so that boards and directors can identify problems and intervene early.
- How do we go about levelling the playing field so that competent people with more collaborative personality traits can reach the top? What role does competition play in driving behaviour and how can we harness that to support more productive business practices?
- Boards need to see culture as integral to delivering their strategy and not as an add-on.
- But focusing on boards alone ignores the operational culture that has to apply throughout an organisation, as affecting its behaviour.
- The question of diversity and cultural fit is interesting, because those things are often at odds with one another. The more you fit, the less you challenge. There is often insufficient challenge. There exists a very real tension between getting agreement and shared cultural sense, and who is going to call out a problem.
- A lot of this is common sense, but we don't actually make space to apply common sense very often. Diversity is actually about giving ourselves space in which to apply common sense.

Diversity often becomes a way to comply, to show good corporate behaviour, but there's no real belief in the fact that diversity will bring superior results. Even if you have a diverse board in terms gender and other measures, if the board members all tend to think in the same way you have no diversity of views. There's a whole different view of diversity, a much richer view that incorporates things such as age, personality type, ideological views, which we need to engender.

- We tend to think about culture as a top down thing but actually it is as much bottom up.
- The founders of the business also have a key role to play in setting consistent values and the context for corporate culture. The average age of a company in the FTSE 100 is probably not older than 12 years. Where are these businesses that have really survived over centuries?
- You don't get a culture by talking about culture. It involves many granular decisions.
- Education is essential at all levels. This is true in primary and secondary schools and in business. There is a need for ethical discussions. The Financial Ombudsman has a weekly ethical dilemma that staff discuss. It may have nothing to do with financial services, but it engages people with problems and thinking about how to handle them.

Structure & Regulation

- The UK has very high levels of compliance with the Corporate Governance Code, over 90% in the upper echelons of the FTSE; yet we've witnessed a series of corporate scandals that have damaged the reputations of some of our largest companies.
- Regulatory systems need to be supportive and work in collaboration with the industries they regulate. This can then allow a nudge concept to be applied to behavioural change and an approach focused on positive communication rather than increasingly strong deterrence. Reducing deterrence barriers would permit a proper relationship and conversation, building trust in each other. This applies to regulators as much as to those they are regulating.
- The difficulties in the financial sector suggest it would be best to change this regulatory relationship in other sectors first to prove the model and its efficacy, before tackling financial services, where there is still a desire from some for blame and punishment for all that went wrong. Nobody has yet come up with a truth and reconciliation commission for financial services.
- How can businesses set sound standards rather than being forced to do so by regulators? One strategy within financial services would be to get the culture right in the companies, to set an example to the FCA and the CMA.[1]
- In both civil aviation and pharmaceuticals the effect of not doing the right thing is very dramatic and public. Pilots in particular have their own lives on the line. They must fix problems if they don't want planes to fall out the sky. There is forensic reporting on any failures or risks that is probably not considered in financial services.
- The concept of 'Ethical Business Regulation' is beginning to spread, and to be taken up by government and regulators in some sectors. It provides an opportunity for those who believe in the importance of ethical values to spread them. There are opportunities here for the Church.
- Do we pay sufficient attention to the way in which economic and market structures can affect behaviours, for example quantitative easing and the resultant low bond yields that that is generating? What about the use of house prices as an economic and policy tool and or the legal structure of the limited liability company which arguably could create moral hazard?
- How do you have a consistent culture when different companies are brought together through merger to become a joint stock company where nobody owns more than 1% and leadership dissipates?

International Dimensions

---

[1] Competition and Markets Authority

- Culture varies around the world. Finding a common set of values for a company around the world is more difficult than when the City was more locally structured and focused.
- However, there is scientific evidence that all humanity has a moral compass as part of human DNA. It is the capacity for ethics that is a major differentiator of humans from other species.
- Realism is required about the challenges of ethical and cultural formation in international businesses with operations in multiple jurisdictions each with different legal and regulatory regimes and potentially different ethical norms and cultural expectations. In turn, an international shareholder base may not have shared assumptions regarding the importance of ethics and culture within a business.
- Can you achieve a comparable culture across boundaries? What is important to people as human beings is remarkably similar. Language might get in the way, from one part of the world to the other, but values are often the same.

Private vs. Public Interests

- Is there an inherent conflict between the common good within the UK and the interests of a business organisation that holds itself out as interested in serving its community? Law, regulation and enforcement are there because companies are privately owned and ultimately serve private interests. Law and regulation are publically imposed standards intended to limit the extent to which private interest can trump the public good.
- The human factor is what makes all of this so difficult. We are battling human nature and the pursuit of self-interest which is why governance and shareholder rights exist in the first place. Is it possible to eliminate the tension between the pursuit of profit and wider corporate responsibilities?
- How does the regulator maintain independence within the system? How do we guard against the risk of regulatory capture?
- Is there a point at which taking account of the interests of other stakeholders – other than shareholders – can be detrimental to business performance?
- Brand reputation matters both prospectively and reactively in a crisis.