Encik Abdul Rasheed Ghaffour: The ethical challenge – building a culture of professionalism and integrity

Remarks by Mr Encik Abdul Rasheed Ghaffour, Deputy Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the AIF-FSBP Business Ethics Conference 2017 "The ethical challenge: building a culture of professionalism and integrity", Kuala Lumpur, 24 April 2017.

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Ethics is not a new topic. It has been talked about for thousands of years. Plato claimed that "Good people don't need laws to tell them to act responsibly, and bad people will find a way around the laws". In essence, he suggests that there are "good apples" and there are "bad apples". More controversially, he implies that the state of the apples has nothing to do with "the barrel". I am sure that many of us in this room are probably inclined to disagree. But while ethics has been discussed and debated throughout the ages, it has been put into sharp focus lately. This is especially so within the ambit of the financial industry. It is therefore an honour to address you today at the onset of this conference.

The need for ethics

Prior to the global financial crisis, the focus of investors, financial firms and even many regulators fell primarily on strong balance sheets and robust internal controls. While necessary, these were not sufficient. Many financial institutions still failed to function as they should. In a 2009 report on the crisis, the OECD observed that "corporate governance routines did not serve their purpose to safeguard against excessive risk taking". A crucial shortcoming in many cases was the corporate culture within financial institutions. It is therefore no surprise that "weaknesses in risk culture are often considered a root cause of the global financial crisis". We all know too well how loans were systematically sold to people who were clearly unable to repay. Lenders operated on a legal, but ethically questionable, originate-to-distribute business model – this saw the risks associated with sub-prime mortgages being repackaged and sold off to unsuspecting third parties.

Another sobering example of the link between culture and crisis comes from a finding of the Financial Crisis Inquiry Commission in the United States on Lehman Brothers. The Chief Risk Officer was stripped of her role after raising red flags on risks, in the face of intense competition from other investment banks. As we all know, the bank went on taking much more risk that it could reasonably manage – and the rest, is history.

While the global financial crisis has inspired much conversation about ethics and culture, these issues are by no means new. Throughout the 2000s, an estimated 45 million payment protection insurance (PPI) policies worth around £44 billion were widely mis-sold to customers in the UK. Many people did not even know that they were buying a PPI policy. In one example, a PPI policy bundled with a mortgage – cost the customer more than £20,000 over the term of the loan, even though the maximum amount claimable was only £31,000! The FSA reported that this abuse stemmed from "a culture in banks and other firms that focussed on profit over customer outcomes". Closer to our region, we saw in 2001 the unexpected failure of the Australian HIH Insurance Group, which experienced estimated losses totalling AUD 5.3 billion. This was attributed in part to a culture where the board was "unduly deferential" to management, and staff simply did not question leadership decisions.

In fact, instances of failures in professionalism and integrity do not seem to have waned since the global financial crisis. According to the Boston Consulting Group, banks have paid fines amounting to USD 321 billion to regulators around globe since the crisis through the end of 2016. Instances of misconduct range widely – from the well-known rigging of LIBOR and Euribor rates, to the more recently uncovered case of Wells Fargo, where over 2 million fake accounts were opened under a senior management who fostered “an atmosphere that prompted low quality sales and improper and unethical behaviour”.

Our financial industry is not invulnerable to the ethical challenge. In the 1980s and 90s, we had cases of Malaysian banks that suffered significant losses arising from imprudent lending under ethically questionable decisions by top management. In the past two years, more than RM 100 million in fines were meted out for breaches under the purview of Bank Negara Malaysia and the Securities Commission Malaysia. A study led by the University of Malaya and the AICB in 2014 revealed that 43% of employees within the Malaysian conventional banking sector “had observed or had first-hand knowledge of wrongdoing in the workplace”. I believe that the survey findings which the FSPB will present later today will reveal that not enough has improved since then. It is crucial and timely that we take the ethical challenge seriously in Malaysia. We must ensure that the unflattering history that we have seen elsewhere does not repeat itself here. As stewards of the people’s money, the finance community must step up to the moral obligation we owe to our society.

Making sense of ethics

We have seen some shocking behaviour around the world of finance in recent years. The examples I have relayed are replete with “greed”, “dishonesty” and “recklessness”. We are led to consider – how can respectable and well-educated human beings behave in this way?

In answering this question, I find the work of Philip Zimbardo on the psychology of evil to be very helpful. Ethics is a slippery subject. Concepts like professionalism and integrity are inherently subjective. As financiers, we often feel – out of our depth – when dealing with issues of human behaviour. We tend to be more comfortable with hard numbers and data. This is why I find it helpful to draw insights from psychology. Zimbardo’s work draws from well-known controlled studies such as Milgram’s electrocution exercise and the Stanford Prison Experiment. He also examines real-life cases like abuses in the Abu Ghraib and Guantanamo Bay prisons. All these cases revealed that ordinary people are a lot more capable and willing to engage in shocking and unethical conduct than we would expect. For instance, the prison studies uncovered deeply disturbing abuses by guards in both real-life and controlled settings. Verbal insults. Humiliation. People being treated like animals – all these by men and women who had loving families, a good upbringing and otherwise ordinary lives.

Zimbardo proposes a threefold framework of “system”, “situation” and “person” to make sense of the factors affecting such behavioural choices. He points out that ethical and behavioural choices are often the result of a dynamic interplay. “What do the people bring into the situation? What does the situation bring out of them? And what is the system that creates and maintains that situation?” It is fascinating to note his conclusion that “personal” convictions matter, but only slightly. The overwhelming evidence shows that the “situation” and “system” – pose the greatest influence on behaviour. While this appears to paint a grim and depressing picture of humanity, I believe that there is a silver lining here. These findings suggest that, given the right “situation” and “system”, people are capable of much good – even in the highly-competitive and fast-paced world of finance. In other words, the problem is often not so much about the “people” or the “bad apples”, but the “bad barrels” – that lead to shocking behaviour.

The ethical challenge for us as leaders in the corporate and public sectors is to build this conducive culture. The need is to cultivate the situational environment and broader system that encourage genuine professionalism and integrity of the people in the system. Let us focus on these three elements of (a) system; (b) situation; and (c) people.

(a) System

Let us begin at the highest level, the system. This represents the values and assumed beliefs that underpin an organisation and the financial sector in general. The baseline standards of acceptable conduct and behaviour are articulated formally through laws and regulations. In Malaysia, the legal and regulatory frameworks for the financial sector are stewarded by Bursa Malaysia, Securities Commission Malaysia, the Companies Commission Malaysia and Bank Negara Malaysia. Various efforts have been, and are, taking place on the professionalism and integrity fronts. The Bank recently issued the enhanced corporate governance standards for the financial sector – calling for a culture that reinforces ethical, prudent and professional behaviour. I understand that the Securities Commission is currently finalising a revised Malaysian Code on Corporate Governance which will be applicable to Bursa-listed firms. Just this month, a Code of Conduct for the Malaysian Wholesale Financial Markets was issued by the Bank. It is targeted at raising the bar of professionalism and integrity of participants in the money and foreign exchange markets. In line with the focus of many prudential regulators worldwide, the next phase of our efforts in strengthening corporate governance includes enhancing our supervisory toolkit to effectively address culture. Beginning 1 January 2018, the Bank will also be introducing a strengthened transparency framework for our enforcement actions, to serve as a deterrence against misconduct.

At the same time, we have to be realistic. There is only so much regulation and supervision can achieve. Firstly, because enforcement actions are ex-post, occurring only after a finding of misconduct. Secondly, because not everything unethical is illegal. Morality cannot be legislated. The spirit of the law may be violated even when the letter of the law is kept. As such, while public sector efforts are necessary to ensure minimum universal standards, the values for the financial sector are ultimately solidified by private sector forces. In particular, professional bodies have a crucial role to play. This role includes – but is not limited to – promoting competence within the financial sector. Beyond training, these organisations are uniquely positioned to build for financiers, a sense of pride and societal purpose toward their vocation. The Asian Institute of Chartered Bankers (AICB) is making substantial progress in this direction for the banking profession. I am pleased to note that its flagship Chartered Banker curriculum dedicates a significant emphasis on professional ethics. This stands alongside various other efforts for training and standard-setting, including those by AIF, ICLIF, SIDC, FIDE Forum, PPKM and FSPB. I wish to take this opportunity to specifically commend the AIF and FSPB for their initiatives, including today's event. These draw the much needed attention by the industry to this important subject.

The system of values affecting behaviour does not only depend on the sector-wide legal and regulatory frameworks and the vibrancy of the professional community. Also, of crucial importance, is the role of the board and senior management in each organisation. As has been often repeated, these leaders set the tone from the top. This is established through official decisions and formal statements, including the corporate values and various codes of conduct. However, their role goes much further than that. More than their words, the board and senior management determine the prevailing values of the organisational ecosystem through their attitudes, actions and decisions – especially those relating to professionalism and integrity.

- Do they give the impression that the ends always justify the means?
- How vigorously do they question sudden surges in a business unit's profitability?
- Are they willing to overlook ethically questionable actions so long as the firm is technically within the bounds of the law?
- How do they react to ethical failures and misconduct? How does compromising the policies of the organisation affect bonuses and promotion?

Apart from the board and senior management, the system affecting each organisation is also determined by the shareholders. The capitalist system depends on owners of capital to promote sustainable value creation through market discipline. Is it simply short-term profits that matter? Are there other social or environmental purposes that must be safeguarded? To this end, the Securities Commission's Malaysian Code for Institutional Investors articulates the stewardship role that shareholders ought to play. Ultimately, shareholders need to clarify that – we need more than just the bottom line – immediate profit is not everything.

(b) Situation

Let us move on to the second element – the "situation". The system of values creates and maintains various situations. The situation represents the environment or immediate setting in which financial industry professionals operate. This is a broad subject. Today, I wish to focus on two types of situational incentives. Firstly, remuneration structures. And secondly, the attitudes toward speaking up.

Remuneration plays a significant role in influencing behaviour, including ethical choices. Admittedly, the task of designing and implementing a remuneration system to encourage professionalism and integrity is not straightforward. However, the intuition is simple and attainable: financial institutions should avoid the folly of rewarding A, while hoping for B. In other words, we cannot hope for or expect ethical behaviour so long as we continue rewarding people for acting otherwise. In this regard, the Bank is currently phasing in requirements consistent with international standards to align remuneration with prudent risk-taking – with a focus on material risk takers. These rules emphasise sensible governance structures – such as preventing control function officers from having their bonuses determined by the profits of business units they oversee. They also require risk-adjustments in quantifying bonuses – for instance, two traders who bring in the same profits, but expose the firm to different levels of risk, are rewarded differently.

The other area that is important to fostering a healthy culture at the situation-level is "speaking up". It is important that there are clear and robust whistleblowing arrangements for employees to raise legitimate concerns about illegal or unethical practices. In addition to the statutory protection offered for whistleblowing to authorities, it is also important that financial firms have internal arrangements for concerns to be raised within the organisation. However, whistleblowing only makes up a small portion of a speaking up culture. In fact, it is a last resort which will not need to be used in an organisation with a healthy culture of open discussion. For professionalism and integrity to prevail – it is crucial that financial firms encourage constructive challenge and healthy debate. This is particularly pertinent for the more ambiguous issues of ethics, professionalism and integrity.

(c) Person

We have discussed the elements of "system" and "situation". The third element that is critical for a healthy culture is that of the "people". I pointed out earlier that the evidence of psychology suggests that the "system" and "situation" are far more likely to predict actual ethical behaviour compared to personal convictions. This is somewhat comforting, because it means that a huge part of the ethical challenge can be addressed without the need to reform people from within. The problem of "bad apples", it seems, can be largely solved by focusing on cleaning up the "bad barrels". However, the element of "people" remains relevant in determining behavioural outcomes – even if to a lesser extent. Again, this is a very wide and complex subject, but I wish to briefly mention two key points.

First – we must remember that the financial sector, like human society, is made up of moral creatures. We cannot live, much less flourish, unless we recognise this and begin to employ the language of ethics in business. The language of business must align with what most people feel about how to live well: be honest; give trust; create lasting values; be reliable; and take pride in your work. The evidence reveals that employees are much more productive, and feel more fulfilled, when they believe that they share the same values as the organisation they work for. My point is simple – we must not shy away from the language of morality and objectivity in finance. Yes, there are many ambiguous areas. But some things are right, and some things are wrong; and as moral creatures, we should engage on these terms, even in business. Morality does not cease to exist when we go to work. If dishonesty is unacceptable, then it is unacceptable regardless of whether we are dealing with a neighbour or with a counterparty. The global financial crisis has been a sobering reminder of why we must not divorce ethics from finance.

Second – we must all face up to the difficult but necessary decisions of keeping out bad apples from the financial industry. Recruitment and promotion plays a key role here. Organisations should pay careful attention to the individuals they hire and promote. Recruitment assessments should be done with utmost vigilance, and financial firms must be more candid in dealing with cases of misconduct. Complaints and suspicions should be investigated properly, with an opportunity for the individual in question to make representations. If their name is cleared, then this should be recorded, to protect them against unfounded accusations in the future. If they are found to be in the wrong, then proportionate disciplinary action should be taken and recorded. Often, bad apples are allowed – and even requested – to leave quietly before investigations are opened. This leaves them with a clean record to go on and stir wrongdoing in another organisation, and the next, and so on. This practice should stop. We are collectively responsible for upholding the integrity of our entire industry, not just our respective institutions. What is important is transparency, to allow the job market to make informed decisions. In this regard, the Bank is currently pursuing an initiative that will mandate the sharing of employment references with future employers. A key objective for this is to mitigate the problem of 'rolling bad apples' within the Malaysian financial industry.

Conclusion

Business ethics has become a popular topic in the world of finance. We must be careful not to pay lip service to the hype. We must be careful not to pretend that it can be addressed with simplistic solutions. We must instead take a holistic, thoughtful and realistic approach in building a culture of professionalism and ethics. Allow me to conclude here by leaving you with three key messages–

First – we cannot afford to underestimate the power and danger of "bad barrels". The evidence demands that we focus carefully on cultivating a "system" and designing "situations" that encourage continuous ethical behaviour. This is a shared responsibility. As I have said, regulators play a crucial role in articulating the letter of the law. But it is the private sector leadership that determines whether its moral spirit will be pursued.

Second – we must not neglect the uncomfortable reality that there are "bad apples" out there. A clear message needs to be sent out, that the financial industry does not have room for these. Fair, proportionate and transparent disciplinary action will be central in communicating this message.

Finally – the entire financial sector must embrace the language of ethics and objectivity. Just like in any human relationship – trust, honesty and integrity are moral values which must permeate through the business. Perhaps it is fitting that I end by quoting from a great icon of professionalism in finance, the late Tun Ismail Ali. And I quote:

"It is timely that we should examine the real meaning of integrity, hard work and capacity for efficient management of our affairs, accountability and corporate citizenship"

These words still ring true today. As leaders, our challenge is to emulate his example of building a culture of genuine professionalism and integrity – one that sinks into the very DNA of the financial industry. I wish you all a fruitful session today as you think through and discuss these interesting issues together.