⇨ Luc Van Liedekerke / Wim Dubbink

Banking in Crisis: towards a Responsible Organisation

Hanlon's Razor: «Never attribute to malice that which can be adequately explained by stupidity».
Attrib. to Robert J. Hanlon

Douglas W. Hubbard, The Failure of Risk Management: «Never attribute to malice or stupidity that which can be explained by moderately rational individuals following incentives in a complex system of interactions».

The current financial crisis is in many respects historic. The scale of the crisis, the tremendous speed and the massive impact on the world economic system immediately referred to the great depression. The crash came as a surprise, a system that functioned well for over sixty years all of a sudden collapsed. But that is in a sense a serious delusion. Figure 1 gives us an overview of banking problems for the period 1980-1996 for the entire world. Only the non-shaded countries escaped crisis, and as one can see, these are usually countries with a marginal or even non-existent banking system. Between 1980 and 2000 130 out of the 180 members of the IMF experienced serious financial problems. The average cost of a banking crisis attained 12% of GDP and could reach up to 40% (e.g. Argentina; Indonesia). Whether we like it or not, we need to start from the assumption that the financial system is inherently fragile; much more so than the non-financial part of business. This is why the financial system is much more regulated than the non-financial system. And still regulation failed massively.

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Banking problems worldwide, 1980-96

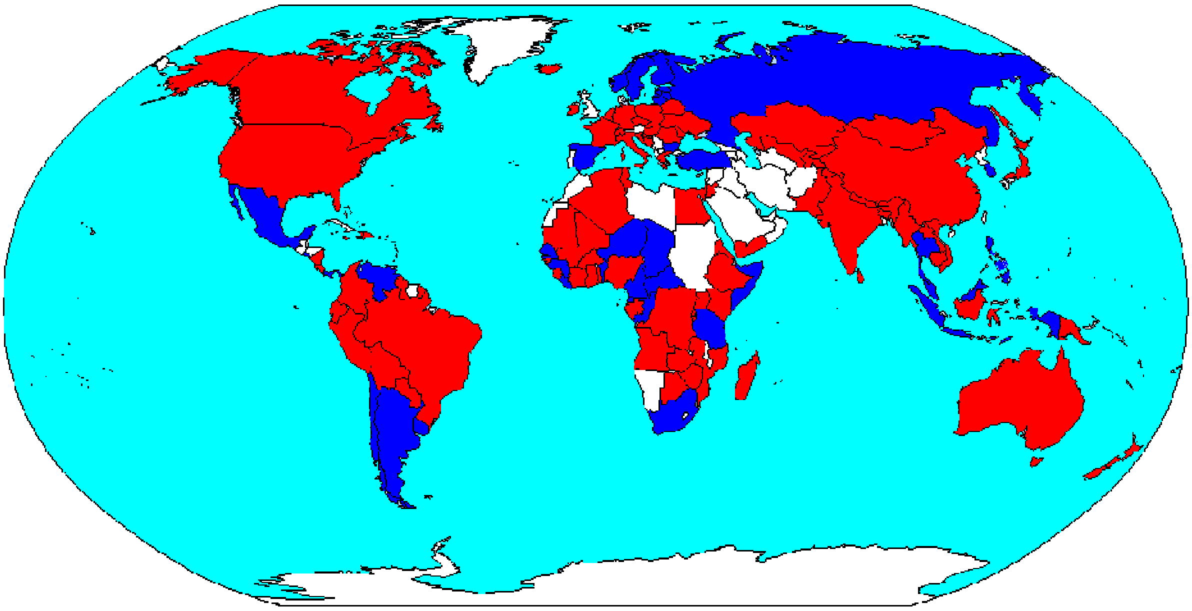

Figure 1 (De Grauwe 2008)

Although this crisis is in terms of scale and impact certainly not comparable to any of the previous financial crises; looked upon from a pure business ethics point of view it is comparable to several other crises of our economic system. In order to illustrate this we will develop a parallelism between the Enron, Worldcom, Ahold, Parmelat etc. crisis that struck the world around the twist of the millennium and the current financial crisis. We will indicate a number of close parallelisms between both crises. In a second step we look for reasons that help us explain the collective nature of the failing. There are many, but in this contribution we would like to focus on organisational processes that affect the way in which people frame their responsibility. This is a part of the story that is all too often forgotten. We believe that the framing of responsibility in modern organisations played an important part in the Enron Worldcom disaster as well as in the financial crisis. For one thing, framed responsibility led to a massive failure of common sense and if not adapted will cause many more crises. We end with a plea for the value of what the Greeks called *parrèsia,* a certain frankness in speech, a critical attitude, which we believe should play a better part in the organisational culture of companies.

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⇨1 From Enron to Lehman Brothers: a remarkable parallelism

The Enron, Worldcom crisis that exploded around the turn of the century was quickly recognized as a classic case in business ethics. Almost all companies involved in this crisis wave were characterized by a number of common characteristics:

- Enormous expansion through take over activity over at least the past five years
- The financial backing for this expansion was delivered by an ever rising share price. For the survival of the firm it was crucial that the stock price remained high at all cost.
- But as common sense can tell you, the economic system is cyclical in nature and it is therefore highly unlikely that the economic indicators of a company can only rise. Still the strategic growth model behind Enron, Worldcom etc. did not allow for a slip in share price.
- When the cyclical turn took place the companies had only two options: stop growing and run the risk of being taken over by your competitors or lie about your results through the application of advanced accountancy techniques (cooking the books).
- Product innovation in the field of accountancy (e.g. special purpose vehicles allocating debt outside the official balance) allowed the companies to bend the rules of accounting.
- The know-how for these new accounting products was delivered by the same companies that were supposed to control the books; Arthur Anderson being the most dramatic example but certainly not the only one. In general all the big auditors found themselves in a conflict of interest situation that proved detrimental to market stability.
- The end result was massive regulatory arbitrage; usually well within legal boundaries, but with a clear target of escaping the accounting regulation that was created in

order to guarantee market stability by creating financial transparency for international corporations.

- Trust (in financial accounts) proved to be the basic value involved in this crisis. Once the trust was gone a rapid breakdown developed. Arthur Anderson, a worldwide multinational with a strong reputation evaporated in a matter of months.
- Not all strong growth companies and not even all auditors made the same mistake.

Now let’s jump towards the financial crisis and remark the close parallels.

- Strong expansion at least over the past five years. Figure 2 contains the balance sheet (total assets) for the seven top European banks from 1997 till 2007. It shows an explosion of the balance sheet. An extensive part of this increased activity will turn out to be hot air.

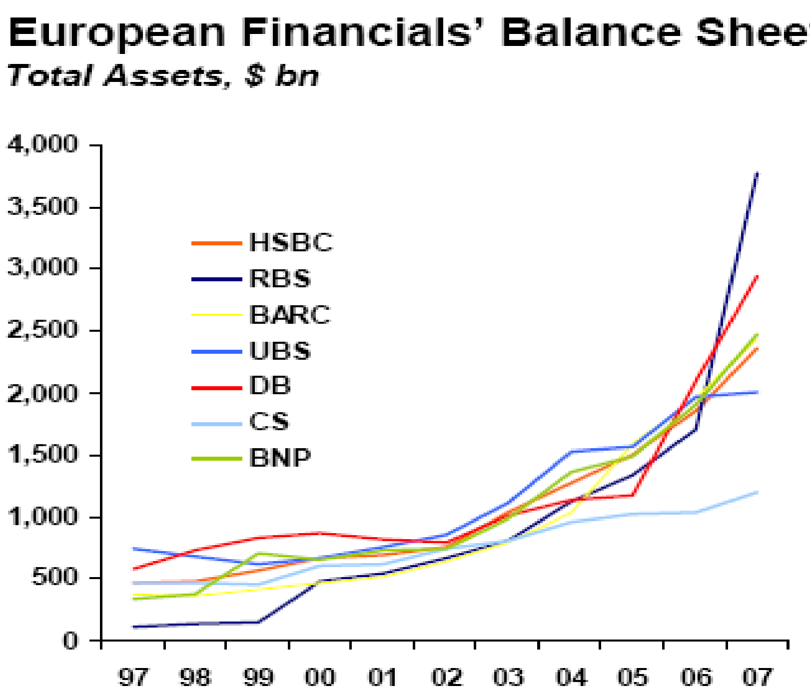

Figure 2

- With Return on Investment (ROI) around 20% share prices in financials rallied. But as common sense can tell you, it is highly unlikely that anyone can continue to deliver such a return on investment for any prolonged period of time.
- Massive product innovation (CDO, CDS etc.) created the enormous growth in the balance sheet and allowed for the high return on capital.
- The know-how for these new products came from investment bankers. But rating agencies (S&P, Moody's, Fitch…) were also closely involved. They acted as consultants, helping out banks to develop these new products in such a way that a triple A rating became possible. This «reliability stamp» allowed rapid spreading of the product. Like the auditing firms, the rating agencies were clearly involved in a conflict of interest that was, once again, detrimental to market stability.
- Basel I, a world-wide regulatory framework that aimed at market stability, was perceived as an annoying obstacle on the road that was carefully circumvented. Banks copied each other's behaviour and massive regulatory arbitrage, again well within the legal framework, was the net result.
- Trust (in bank stability) proved to be the basic value involved in this crisis. Once the trust was gone a rapid breakdown developed. Bearn Stearns was the beginning, Lehman Brothers the decisive moment and after that it was often a question of days before a bank collapsed.
- Not all banks made the same mistake.

Why did some firms succeed in escaping the crisis and why did others not succeed? It is a question that can and has been analysed at many levels but we will limit ourselves in this contribution to a business ethics point of view where we concentrate primarily on the organisational ethics involved.

⇨2 Functional differentiation and constricted responsibility

Formulated in Weber's terms modernity is characterized by the existence of complex organisational structures that rely heavily on functional differentiation. At the level of the firm as Adam Smith already pointed out in his famous example of the pin factory labor specialization is the most visible form of functional differentiation and one of the key success factors of the modern enterprise. While Smith praised labor specialization in book I of the *Wealth of Nations*, he criticized it at the same time in book V. His problem there, picked up quickly later on by Marx, is one of alienation of the worker through mechanical labor. For the knowledge worker of today the type of alienation feared by Smith and Marx is far away; there is however another form of «alienation» at stake that can have serious consequences.
Labor specialization is connected with a limitation of responsibility to role-responsibility. Our knowledge worker usually starts out from a job-description containing clear targets and thereby limiting his responsibility. This focuses the employee, and protects him/her from taking on too big a task or getting overwhelmed by the full burden of over-complex organisations. In this sense role-responsibility protects the individual, but there is a price to be paid for this. It prevents individuals from speaking out. Even if you notice a problem, you will not feel the need to say something about this to your boss, why would you? It is not in your job-description, you are not paid for it and it is often not even appreciated. This is, formulated in a loose way, the fate of responsibility in functionally differentiated organisations and it is one that can be fraught with consequences. We elaborate below.

The locking up of responsibility to a limited role-responsibility is strengthened in the modern organisation by several Human Resource techniques.

- A classic example is *job-rotation*. It is looked upon as healthy for the organisation as well as the individual. Employees need to switch jobs in order to keep a challenging environment and to extend capabilities. At the same time, it can lead to the ditching of responsibility. You arrive into a new job, knowing that this is your job for e.g. the next three years but probably not longer. When you arrived into the job there was a pile of unfinished business left over by your predecessors. As the three years run out it is very likely that you will also leave a pile to the one following in your footsteps and often this pile will contain precisely the tricky bits that are not easy to solve. You push the plates towards the others.
- *Benchmarking* is another very popular sport in the modern organisation. It focuses on your relative merit, relative to others, not necessarily on the pure merit of your actions. At the level of the firm we find a comparable story. Companies constantly look at one another in a competitive manner. Benchmarking provides the company with the necessary information to get a relative classification, but if the entire sector is neglecting certain crucial responsibilities the benchmarking will not necessarily change the behaviour of the firm, on the contrary, it will narrow down its consciousness.
- Finally, modern *reward systems*, with a strong emphasis on bonuses, scale down responsibility taking even further. The employee gets locked up in a golden cage where the supervisor is pulling the strings. The bonus culture is often criticized for its (lack of) distributive justice qualities but its immediate danger lies much more in the further narrowing down of responsibility. Employees aiming for their bonus are relatively easy to manipulate, they become like puppets on a string, and in order to be successful at the job will very likely not even

think about taking any responsibility beyond the one that clears their bonuses.

All these techniques strengthen an attitude in employees of looking sideways. Our knowledge worker is often, even after a few weeks into his new job, capable of pointing out weak points in the organisation, but will seldom mention these beyond the small talk at the coffee machine. This failure to stimulate people to take on an extended responsibility beyond their role-responsibility is we believe one of the central limitations of functionally differentiated organisations today. It certainly played its part in the Enron Worldcom crisis as well as in the financial crisis.

⇨3 Towards a responsible organisation

Business ethics is usually identified with a return to personal ethics. It stresses the role of the individual and the importance of living up to certain values and norms, often summed up as the need for integrity. Failures in business are then explained by the lack of integrity in business. It is the bad apples that caused the fruit basket to rot. But that is only half the story. What is striking in the Enron, Worldcom etc. case and certainly in the financial crisis is the collective nature of the failing. This makes it hard to insist on the bad apples story. Who exactly is to blame? Although personal mistakes were made, they are probably quite irrelevant when it comes to explaining the financial crisis. As the opening quotes suggest, it is often not so much malice as plain stupidity that is at work and, one step further, it is not even stupidity but moderately rational individuals that follow the available incentives flowing out of specific organisational settings and institutional structures. Nothing to do with bad apples. If this is right a solution to the problem it demands us to take a proper look at organisational structures and how they can be adapted in order to incentivise people in the right direction. Or, put differently, how do we build a responsible organisation?

In order to answer this question we turn to one of the last seminars of Michel Foucault in which he introduced the classical Greek concept of *parrhèsia* (Foucault 1989). *Parrhèsia* stands for the courageous expression of one's beliefs, however unpopular they might be. It always involves frankness and the full disclosure of one's thoughts and is therefore closely linked with the truth. The man who uses *parrhèsia* is the *parrhèsiastès*, he who withholds nothing, who opens himself to others and who feels the obligation to do so.[1] In his actions courage, morality and truth meet. Morality is involved because the *parrhèsiastès* feels he has no choice but to speak out and in this he shows himself to be a friend of the truth. *Parrhèsia* is necessary in the close personal relation of friendship but is even more important to the functioning of the political community, the polis. This confronted the Greeks immediately with the question of how precisely to incorporate it into the structures of democracy in Athens. *Parrhèsia* was dangerous because it could hurt, at the same time it was necessary because it opened up to the truth. Therefore it was necessary to build in a certain freedom of speech at the Agora, but at the same time the *parrhèsia* needed some control, it could for instance only be used by people with a certain *mathèsis*, a certain experience in political speech who knew how to speak and how to formulate possible rude words. *Parrhèsia* was contrary to rhetoric, contrary to anything the sophist learned. It protected the polis against manipulated speech and decision taking.

Without digging to deep into Foucault's not uncontested interpretation of *parrhèsia*, it is clear that Foucault used this as a mirror to our society (Hadot 1995). Coming closer to a business ethics setting, Foucault's analysis can be translated into the question of how to build critique, in the form of *parrhèsia*, into our organisations. One of the answers we find today, is the creation within the modern corporation of all kinds of safe lines were you can file a complaint or engage in anonymous whistle blowing. This organises the critique in the organisation, but as

(1) In the German translation Passow (1983) talks about «freihes Reden, Freimühtigkeit, Offenheit in Reden und Urteilen».

soon as you organise critique, the critique will tend to go somewhere else. It is by definition hard to control. What is really needed is a change in corporate culture that creates an enhancing environment for those among us that want to speak out. Decision making within the organisation is not limited to the top of the hierarchy. It often even does not take place at the spot designed for this (e.g. the boardroom); it can take place at golf courts, while skiing etc. Therefore the entire organisation should unfold itself as an inherently critical space supported by an ethics of conversation where speaking out is not only tolerated but actively solicitated for.[2] This is certainly far removed from the present organisational structure where people dangle at the thread of bonuses. You see things, you hear things, you are convinced that you can do better, but nobody speaks out. We call this the moral muteness in organisations, and it is up to a great extent the sad situation in which many employees find themselves today.

To break this barrier we need to redesign the organisation at all levels. We need to question whether it is the case that people can speak out in our organisation; whether our bonus system is designed in such a way that it helps criticism to surface or rather blocks it from leaving the coffee bar; whether we have systems in place that pick up the voice of those speaking out and push their voice through the organisation all the way up to the top. Corporate governance rules should exemplify the possibility to raise your voice inside the group without risk of exclusion or retaliation. A governance team with people from all levels within the firm could function as a guardian of the speech freedom of peace loving people.

All this presupposes however that people carry a natural capacity to speak out. Unfortunately, this is not always the case. Not everybody is fit to be the *parrhèsiastès*. The existence of

(2) Richard Rorty follows the same idea at the level of society. His pragmatist society is driven by a constant willingness to talk and listen; it enacts the Socratic conversation values. See Rorty 1982, 191-210.

role models, examples of people speaking out, conversational training aimed at learning to take a critical look at an organisation and formulating your perception might help but is by no means a guarantee. The road towards the critical organisation is long and hazardous, but if we refrain from taking this road collective failures of the economic system will continue to happen.

⇨Conclusion

The crisis in the financial system was massive, unannounced and hit us like a perfect storm. Nevertheless from a business ethics point of view this crisis is not different in nature from previous crises that battered our economic system. We see the same mistakes return over and over again. It would be naïve to blame the failure of the financial system on evil bankers. Malice is not concentrated in bankers. We can only understand the massive nature of the failing if we take the organisational and institutional structures that mould the behaviour of individuals into account. In this contribution we concentrated on the organisational part. Complex organisations limit the responsibility of persons to their role-responsibility. Going beyond that is not encouraged or even punished. This implies that at all levels of the organisation we are confronted with moral muteness, the unwillingness to speak out when confronted with practices which you consider to be problematic. Tackling this is not an easy task but starts with opening up the organisation to critique. An open organisation where critical conversations can play a part and criticism is not immediately isolated or excluded is a powerful weapon against mistakes. If our banks dare to take this road chances are that by the next crisis moment more banks will be able to stay out of the crisis because somewhere within the bank somebody retained his common sense and spoke out to indicate that this growth model of the bank was not viable in the long run.

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