Character's Essential Role in Addressing Misconduct in Financial Institutions

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This article examines one of the critical causes of misconduct that has persisted in the global financial services industry despite the warning flags raised from the financial crisis of 2008–09 and the very public shaming of major financial institutions (FIs) that have violated various regulatory regimes.[1]

The authors argue that many acts of misconduct are consequences of failure of judgement owing to weaknesses in leader character. By so doing, the article pivots away from the prevailing popular wisdom that such acts of misconduct are consequences of the moral or ethical shortcomings of 'bad' people. Rather, it takes the view that these acts of misconduct are usually the result of poor judgements made by people with underdeveloped character dimensions working in organisational cultures that allow or encourage them.

The article defines character as an amalgam of virtues and values that, individually, collectively and interactively affect the way leaders perceive situations, as well as make and implement decisions. The principal dimensions of character are integrity, drive, collaboration, humanity, humility, justice, courage, temperance, accountability, transcendence and judgement (see Figure 1). The authors' research suggests that character can be assessed and developed, and that leaders with character can infuse character-based decision-making into the culture of the organisations they lead.

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* The views expressed by William Furlong (who is also a Commissioner at the Ontario Securities Commission (OSC)) in this article are his and do not necessarily represent the views of the OSC.

1 This article is based on the substantial body of research by a team of researchers under the auspices of the Ivey Ian O Ihnatowycz Institute for Leadership.

When we use the word 'leader', we are not just referring to those in formal, positional leadership roles such as chief executive officer (CEO), chief financial officer (CFO) or chief risk officer (CRO). We also include those who are willing and able to exert influence on leaders. Legal and financial advisers, for example, may not be in executive roles but they can have a substantial influence on the ways in which executive leaders frame and understand issues and make their decisions.

Further, the authors contend that lawyers could and should play an important role in preventing such misconduct if they had a better understanding of the effect that character has on executive decisions. Whether as trusted advisers, compliance professionals, inside counsel or regulators, such understanding would enhance the quality of advice they give or actions they take and would prevent them becoming complicit in wrongdoing. Beyond that, they could become an integral part of building healthy, sustainable organisational cultures that quickly recognise and address potential misconduct even before it happens.

In this article the authors:

- describe the types of poor conduct that have continued to plague the financial industry since the onset of the financial crisis;
- review the media coverage and academic literature that has tended to analyse and frame misconduct as an ethical or moral issue and why, framing it this way, the solutions designed by regulators, boards and management to address it has been met with only limited success;
- introduce a more complete interpretation of the sources of poor conduct and misbehaviour in the financial industry using the Ivey Leader Character Framework;
- discuss the implications for FIs, regulators and their legal advisers, justifying the authors' position that character must be a legitimate topic of conversation, exploring lines of inquiry related to character, and suggesting criteria by which responses could be assessed; and
- finally, propose how this approach to character might be implemented in ways that will strengthen the business judgement of the leadership, organisational culture, and approach to risk management and regulation throughout financial services organisations.

Poor conduct persists in the financial services industry

Since the 2008-9 financial crisis, there have been numerous and widespread instances of poor conduct continuing to take place within FIs across the globe. Some of the more egregious, recent examples include:

- *Retail fraud*: In September 2016, Wells Fargo will have to pay US$185m to settle charges that its employees had fraudulently created more than two million deposit and credit card accounts in order to achieve performance targets and earn bonuses. Wells Fargo employees created personal identification numbers (PINs) and fake email and phone addresses for the fraudulent accounts.[2] Ultimately, more than 5,300 bank employees lost their jobs, CEO John Stumpf resigned and Wells Fargo now faces an array of new investigations and lawsuits related to the matter.
- *Forex market manipulations scandal*: Global banks will pay more than US$10bn to settle allegations that they rigged the US$5tn daily forex markets. A notable quote from an unnamed trader as written in a 5 November 2010 chat: 'If you ain't cheating, you ain't trying.'[3]
- *Money laundering*: In December 2012, HSBC Holdings plc ('HSBC') reached a US$1.9bn settlement agreement with the United States Department of Justice to resolve charges it enabled Latin American drug cartels to launder billions of dollars from the mid-1990s to 2010.[4] Despite HSBC spending nearly US$3bn annually and tripling the number of compliance staff to around 9,000 people, a monitor overseeing HSBC's compliance with this settlement has found numerous lapses. 'The monitor's findings, which date from 2015, suggest that despite three years of efforts to bring compliance up to U.S. standards, HSBC is still struggling to meet the terms of the deal.'[5]
- *Rogue trading scandals*: There have been numerous rogue trading scandals uncovered in recent years, the larger ones including JPMorgan Chase's 'London Whale' (2012, approximately US$5.8bn loss) and UBS's Kweku Adoboli Equities Trading (2011, approximately US$1.8bn loss).

In a recently published study by Boston Consulting Group it is estimated that, since 2008, banks have paid fines of US$321bn. In 2016, banks paid fines of US$42bn, an increase of 68 per cent from 2015. Boston Consulting Group believes this amount will increase 'as European and Asian regulators catch up with their more aggressive US peers who have imposed the majority of fines to date'.[6]

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2 Lucinda Shen, 'Wells Fargo Has Been Fined $185 Million for Opening Unauthorized Accounts' *Fortune* (8 September 2016).

3 Lindsay Fortado and Katie Martin, 'Serious Fraud Office drops UK criminal forex probe' *Financial Times* (15 March 2016).

4 US Department of Justice, 'HSBC Holdings et al Admit to Anti-Money Laundering and Sanctions Violations, Forfeit $1.256 Billion in Deferred Prosecution Agreement' (11 December 2012).

5 Ese Erheriene and Margot Patrick, 'Iranian Miniskirts, Bags of Cash Raise Doubts Over Controls at HSBC' *Wall Street Journal* (30 March 2016).

6 Gavin Finch, 'World's Biggest Banks Fined $321Billion Since Financial Crisis' *Bloomberg News* (2 March 2017).

What makes these egregious breaches of conduct remarkable is that they occurred or continued to occur *after* the 2008-9 financial crisis; *after* the multi-billion dollar bailouts of the financial services industry funded by taxpayers across the globe; *after* the extraordinary measures taken by international banking regulators to increase their oversight of financial institutions, including the hiring and placing of staff within the financial institutions and the creation and passage of thousands of new pages of legislation (Sarbanes-Oxley, Dodd-Frank, United Kingdom and European, etc) had been enacted; *after* industry leaders, governments, regulators and the public at large had been sensitised to misconduct that, if not widespread, had led to severe reputational damage to leaders of financial institutions, especially bankers; and *after* these selfsame financial institutions had committed billions of dollars to the implementation of new governance and oversight programmes, hiring tens of thousands of new audit, compliance and control personnel across the industry. As William C Dudley, President and CEO of the New York Fed, said: 'I was particularly struck by how the manipulation of foreign exchange rates occurred even after the LIBOR fixing was widely known. The appropriate lessons from the LIBOR scandal did not seem to have been learned. That was both surprising and profoundly disappointing to me.'[7]

David Wright, who in 2016 stepped down as secretary-general of the International Organization of Securities Commissions (IOSCO), was quoted as saying that he has 'no confidence that corporate governance and behavior is improving'. He added, 'My view is that there will be more discoveries of anti-competitive behavior, price fixing and collusion. I hope that I am wrong but I fear that I am not'.[8] In remarks made in June 2015 to the C.D. Howe Institute, Office of the Superintendent of Financial Institutions (OSFI), Superintendent Jeremy Rudin stated that OSFI has 'come to see conduct as a prudential issue'.[9] This position was reinforced by Rudin in an article in which he was quoted as saying, 'Regulators need to make sure harder-to-measure aspects of culture – norms and expectations for behaviour – are in place to keep the risk-reward balance in check throughout the financial institution'.[10]

This lack of progress at improving conduct has been a source of real and intense frustration for managements, boards, regulators, industry

7 William C Dudley, President and CEO, Federal Reserve Bank of New York, *Remarks at the Culture Imperative – An Interbank Symposium* (11 January 2017).

8 Chris Flood, 'Cracking down on "megalomaniacs and bullies"' *Financial Times* (24 March 2016).

9 *Away from the Lamppost: Culture, Conduct and the Effectiveness of Prudential Regulation*, remarks by OSFI Superintendent Jeremy Rudin to the C.D. Howe Institute, 17 June 2015.

10 Barbara Schecter, 'Canada's bank regulator probing links between risks and "culture" at financial institutions' *National Post* (7 December 2015).

stakeholders and the public at large. In the US, it has been publicly stated by regulators that if bad behaviour were to persist then 'the inevitable conclusion will be reached that your firms are too big and too complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so that they could be managed effectively'.[11]

Poor conduct incompletely framed as an ethical or moral issue[12]

The media, and the public at large, have framed the persistent misconduct issues in the financial services business as ethical or moral problems. Numerous documentaries (Frontline: '*Money, Power and Wall Street*' aired 24 April 2012, BBC World, The Inquiry: '*Can You Make Bankers Behave Better?*' aired 5 July 2016) and Hollywood films ('*The Big Short*', 2015) have richly portrayed the excesses of the financial services business. Articles from leading periodicals and newspapers support the framing of these misbehaviours as an ethical or moral issue. *The Atlantic* magazine's cover story in its May 2015 issue featured the article 'Can Bankers Behave?'[13] The author cites his own personal experience as an investment banker, interviews other banking professionals, and quotes prominent academics and banking regulators. His concern is 'could Wall Street's deepest flaws be cultural, promulgated over generations by leaders who have chosen to reward those who cut corners, stab colleagues in the back and engage in otherwise unethical behavior?'[14]

Similarly, an article by John Plender in the *Financial Times* invokes John Kenneth Galbraith's concept of a 'stock of moral capital' present in the financial system at any given time, which rises and falls with market prosperity.[15] However, the author asserts that in addition we are witnessing a structural, secular change in this stock of moral capital brought about by an adverse change in ethical values.

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11 William C Dudley, President and CEO of Federal Reserve Bank of New York, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, Workshop on Reforming Culture and Behavior in the Financial Services Industry (20 October 2014).

12 There appears be a broad-based call for improved ethics in all walks of life, including business. Noted columnist and author David Brooks' book *The Road to Character* has been on the *New York Times* Bestseller list since its publication in April 2015. And in the *Harvard Business Review*'s April 2015 edition, its 'Idea Watch' section featured the article 'Measuring the Return on Character', summarising the results of a study that demonstrated that CEOs who rated highly on four moral principles delivered better financial results than those that didn't.

13 William D Cohan, 'Can Bankers Behave?' *The Atlantic* (May 2015).

14 *Ibid*.

15 John Plender, 'The crisis shows moral capital is in secular decline' *Financial Times* (9 June 2014).

There are recent academic studies of human behaviour that strongly support the premise that one's moral fibre is eroded with even minimal exposure to the context of money, financial markets and even banking. According to a study published in the journal *Nature*, people reminded that they worked for a bank ('identity-primed') were more likely to cheat on a coin toss.[16] This study is consistent with previous landmark studies about 'money priming', which demonstrated that people even only subtly reminded of money were less helpful, preferred solitary activities and more physical space between themselves and a new acquaintance (although apparently were ready to work harder and longer!).[17]

The inescapable conclusion for many is that the financial services industry is riddled with 'bad' people, attracted and empowered by an industry-wide culture that allows and encourages them to exploit the weaknesses and loopholes for their own benefit. Philip Zimbardo captured this dynamic in his description of bad apples, bad barrels (contexts/cultures) and bad barrel makers (managements/boards/regulators), with his classic and unsettling 'Stanford Prisoner Experiment' revealing that 'good' people placed in 'bad' cultures end up doing bad things.[18] It is not a stretch for many to conclude that the nature of the financial industry itself creates its own ethical and moral erosion – even affecting 'good' people – and efforts to impose rules to codify 'good' ethics, morals, conduct and behaviour are doomed to fail. Yet the financial industry has been under intense pressure to try.

Limited success of solutions trying to address unethical behaviour

Certainly, regulators, boards and management have a much more nuanced view than the general public of the conditions and causes that have led to persistent misconduct and misbehaviour in the financial sector. There is an awareness of the 'bad apples' that need to be removed before they do more damage to their organisations. There is an awareness of the 'bad barrels' that need to be rehabilitated before they inflict more damage on their stakeholders and the system in general. There is an awareness among the 'barrel-makers' of the need to create policy and governance frameworks that also serve the long-term interests of the societies in which they operate who rely on a stable, fair and resilient financial system.

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16 Alain Cohn et al, 'Business, culture and dishonesty in the banking industry' (2014) 516 *Nature*.

17 Kathleen D Vohs et al, 'The Psychological Consequences of Money' Science (2016) 314 and Kathleen D Vohs, 'Money Priming Can Change People's Thoughts, Feelings, Motivations and Behaviors: An Update on 10 Years of Experiments' (2015) *Journal of Experimental Psychology*.

18 Philip Zimbardo, *The Lucifer Effect: Understanding How Good People Turn Evil* (2008) Rider.

No one seriously advances the belief that morality, although clearly a problem, can be regulated, and even if it could, that it would be a panacea.[19] Nevertheless, regulators continue to try to legislate and regulate what they have defined as morally driven behaviours. The recognised risk in layering on regulations is that it reinforces the transactional tendency to operate within the letter of the law, rather than exercising the necessary judgement required to both understand the spirit of the law and take actions consistent with it.

> '*Virtue cannot be regulated. Even the strongest supervision cannot guarantee good conduct*'
> Mark Carney, Governor of the Bank of England in a speech in London, Ontario, 2013[20]

The solutions proposed and imposed to date – with varying degrees of effectiveness – seem to have at their core an intention to install and strengthen ethical and moral sensibilities for the purpose of positive behaviour modification. Examples include programmes that have introduced codes of conduct, ethics and value statements that explicitly include moral considerations as a baseline standard for behaviour. Compensation systems have been substantially adjusted through payout reductions, deferrals and clawbacks in an effort to reduce the incentives that induce or encourage immoral behaviour. Complex and comprehensive compliance programmes have been designed and rolled out that monitor and report key metrics in dashboard formats throughout all levels of an organisation, up to and including the board.

These actions have been taken by legislators, regulators and in some cases, by corporate initiatives in the expectation that sensitising people to a moral code of conduct, redesigning incentive systems to support this moral code and implementing compliance systems that check key performance indicators will lead to more responsible decision-making and fewer instances of misconduct.

However, these approaches have encountered various forms of resistance. Many in the financial services industry object to the notion that they are ethically or morally inferior or flawed, and programmes that seek to lecture on ethics and morals are often seen as condescending and met with

19 'To regulate for "honest behaviour" and "better culture"… would appear to be fatuous': quoted from Roger McCormick, 'The "Conduct Crisis": Will Banks Ever get in Right?' [May 2015] *Business Law International* p112.

20 William D Cohen, 'Can Bankers Behave?' *The Atlantic* (May 2015).

'flavour-of-the-month' derision.[21] Changes in compensation systems have certainly created better alignment between bonusable employees and their institutions. Yet egregious instances of bad behaviour to preserve bonuses persist, even in situations such as Wells Fargo where the protected bonuses were very modest. Many compliance systems have devolved into 'tick-the-box' exercises where efficiency is more prized than judgement, undermining the effectiveness of the process, and perhaps even engendering a false sense of security. Given the ongoing instances of misconduct it is clearer than ever that simply changing the rules and implementing new processes will not, by themselves, sustainably change culture, and the frame of reference within which people make decisions.

The concern that these approaches have not been as effective as had been hoped is evident in the new programmes that continue to be implemented. In the UK the 'Senior Manager's Regime' (SMR) came into force in March 2016. An article by Tom Osborne on Risk.net described the SMR programme well: 'This regime makes a "reckless" decision that causes a bank to fail a *criminal* offence carrying a maximum of seven years in prison and an unlimited fine. The rules apply to individuals and banks that fulfil 17 designated senior management functions, ranging from the chief executive and heads of risk and finance to the chairs of the risk, audit and remuneration committees.' [22] In a recent speech Mark Carney, the Governor of the Bank of England noted: '…codes [of conduct] are of little use if nobody reads, follows, or enforces them'. He praised the SMR as it 'addresses the common refrain of senior management that they weren't aware that misconduct was taking place in their firms. The SMR re-establishes the link between seniority and accountability. Senior Managers now must take reasonable steps (including training or proper oversight) to prevent or stop regulatory breaches in their areas of responsibility'.[23]

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21 It is clear that people within the financial industry do not perceive themselves as morally 'bad'. Tom Hayes, convicted in the UK and originally sentenced to 14 years in prison for his role in the LIBOR scandal, was the subject of an in-depth article in *The Wall Street Journal*. In the article the author writes: 'He was "getting angrier and angrier" his father, Nick Hayes, later told me. "The more he gave the interviews to the SFO, the more convinced he was of his innocence." And the more he became obsessed with the notion that his planned guilty plea would haunt him for the rest of his life.' David Enrich, 'The Unraveling of Tom Hayes' *The Wall Street Journal* (13 September 2015).

22 Tom Osborn, 'Leeson: risk managers should be personally liable for trades' *Risk.net* (14 March 2016).

23 'What a Difference a Decade Makes', p.7, speech by Mark Carney, Governor of the Bank of England, Chair of the Financial Stability Board in Remarks at the Institute of International Finance's Washington Policy Summit, the Reagan Centre, Washington, DC, 20 April 2017.

However, even the SMR must rely on fines and incarceration for enforcement. But as the evidence of ongoing misconduct demonstrates, the fear of discovery and punishment has proven to be an insufficient remedy on its own. In the same speech Carney stated: 'So while fines and sanctions have roles in deterring misconduct, they will not, on their own, bring about the cultural change we need… we must move from an excessive reliance on punitive, *ex post* fines of firms to greater emphasis on more compelling *ex ante* incentives for individuals, and ultimately a more solid grounding in improved firm culture.' [24]

What is clearly needed now is an approach that impacts and enlightens the individual's conduct at the time conversations are taking place and the choices are being made to activate and exercise the quality of judgement that anticipates the consequences. Such an enhanced level of judgement will be fully aware of the contextual and cultural influences acting on the decision at hand. The individual's judgement is robust enough to not only resist the poor, short-sighted decision, but indeed to exert leadership that will generate appropriate conduct alternatives that positively shape the culture within which future decisions will be made by themselves and others.

Poor conduct reframed as a judgement issue

This article proposes that we are much more likely to prevent acts of misconduct or, if they do happen, to mitigate or ameliorate their negative impact, if we begin to reframe, understand and describe them as poor judgements rather than bad ethical or moral actions. Framing the conduct issue as an ethical or moral problem is ultimately incomplete and inadequate, and may indeed create obstacles to identifying the causes of misconduct and effective approaches to resolution. It would be far better to interpret misconduct and misbehaviour in the business sphere as being a failure of judgement. There are two reasons to support this approach. First, focusing on the quality of judgement not only deals with issues of poor judgement but importantly extends to excellent judgement leading to sustained excellent

24 Ibid, p6

performance.[25] Second, while few people self-assess as having deficiencies of ethics or morality, strengthening judgement is something most people aspire to. Viewing misconduct as a judgement issue instead of a moral issue engages audiences who want to improve decision-making but without the judging that is typically associated with moral agendas. Discussions can be had more dispassionately and rationally, and the audience does not feel themselves under attack. Further, a discerning audience will quickly sense an opportunity to improve their own decision-making and performance, making engagement very much in their own self-interest. By explicitly framing the discussion in the self-interest of the listener we can substantially reduce barriers to engagement.

> *'Banks should look at culture, and achieving consistent behavior and conduct aligned with firm values, as key to strategic success, rather than as a separate work stream or add-on process to respond to short-term public, regulatory or enforcement priorities'*
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> Banking Conduct and Culture, Group of Thirty, p 12, July 2015

25 'In the case of the effects of character, Cameron, Bright and Caza (2004) found that firms whose members possessed more character dimensions outperformed those whose members possessed fewer character dimensions, and in Wang and Hackett's (2016) work, character-based leadership predicted the well-being of both leaders and their followers, along with the performance and citizenship behaviours of employees even after other leadership styles were controlled for. Character dimensions have also been associated with performance on creative tasks (Avey, Luthans, Hannah, Sweetman and Peterson, 2012), job performance (Hannah, Lester and Volgelgesang, 2005; Seijts et al, 2015), executive leadership and performance (Sosik, 2006; Sosik, Gentry and Chun, 2012), executive selection criteria for top-level positions (Hollenbeck, 2009), trust and commitment (Thun and Kelloway, 2011), psychological safety (Palanski and Vogelgesang, 2011), citizenship behaviours (Cohen et al, 2014; Thun and Kelloway, 2011), life satisfaction and well-being (Park, Peterson and Seligman, 2004; Thun and Kelloway, 2011) and ethical behaviour and reduced counter-productive behaviour (Cohen et al, 2014). In addition, in his book on *Return on Character*, Kiel (2015) shows firms of "High Virtuoso" CEOs averaging five times the ROA over a two-year period, compared to their "self-focused" CEO counterparts, and having 26 per cent higher work engagement, and fewer audit problems and lawsuits. In sum, there is evidence to suggest that character enables human excellence and social betterment.' Sturm, Vera and Crossan, 'The Entanglement of Leader Character and Leader Competence and its Impact on Performance' *The Leadership Quarterly* (2016) http://dx.doi.org/10.1016/j.leaqua.2016.11.007.

This latter point is not to be underestimated. Perhaps one of the most significant challenges to changing organisational culture is that of sustainability. Regulators, boards and management are in agreement that meaningful and sustainable cultural change within large financial institutions has been extremely difficult, and that 'accountability must be seen as a new way of doing business, not as a compliance fad'.[26] To emphasise, improving judgement achieves sustainability in two separate, but self-reinforcing ways. First, measures that enhance individual and organisational performance create their own 'indispensability'. Second, the aggregate effect of improved judgements by individuals, in particular those with formal leadership roles, positively influences the culture of the organisation, solidifying the improvements and making it more difficult and less likely that the culture will regress.

Improving judgement using the Ivey Leader Character Framework[27]

The Ivey Leader Character Framework is intended to create superior performance for both individuals and organisations through sustainably improving judgement and decision-making at all levels throughout an organisation, in particular by focusing on those in leadership roles. Once embedded in an organisation it becomes a strategic asset, driving superior performance, while also raising the standards and expectations for behaviour and conduct, enhancing and developing a robust culture that substantially reduces the risk of catastrophic misconduct. A character-infused culture also provides a degree of protection from the truly incorrigible 'bad apples' that inevitably crop up in any large organisation by making their deviant behaviour easier to identify and more clearly unacceptable, which limits their potential for leadership and organisational influence.

In the past, reframing a discussion on character as a judgement issue has been very challenging because character has always been considered a subjective concept, eluding objective definition, not readily and reliably assessed or measured, and has often been regarded as an unchangeable trait, like the colour of one's eyes, rather than as something that can be developed. However, where there is an accessible, convincing, measureable and reliable definition of, and framework for, character (in the judgement sense), which can be developed, this can be an extremely useful business tool in any organisational/industrial context.

26 'Summary Notes: Reforming Culture and Behavior in the Financial Services Industry', p 8, published by the Federal Reserve Bank of New York, 5 November 2015.

27 This framework has been developed over a period of several years by researchers at the Ivey Business School, Western University, London, Ontario, Canada.

With the development of the Ivey Leader Character model,[28] such a framework is now available. Our fundamental premise is that organisations need to elevate character (in the judgement sense) alongside competence for sustained excellence.[29] Doing so requires a rigorous and practical approach to identifying, measuring, developing and applying character in organisations. Research establishes that character is revealed through a set of observable behaviours that support sustained excellence in organisations.[30] Figure 1 depicts the dimensions and elements of Leader Character.

Dimensions are formed of 11 high-level constructs, and elements are the behaviours that represent these dimensions. For example, Integrity is a dimension of Leader Character that comprises more than being principled, including elements such as candour and authenticity, which sometimes make the practice of Integrity difficult, especially when practised in cultures that do not value them. Many organisations identify Integrity as an important value but fail to recognise that simply stating that it is important does not deliver it.

Judgement – at the centre of the framework – reveals that decisions and actions are predicated on the presence or absence of each of these character dimensions. For example, Judgement that is underweighted on dimensions such as Humility or Temperance runs the risk that decisions will be ego-driven and short-sighted, while those that are overweighted on a dimension such as Drive are likely to be rash and lacking in identification of possible outcomes. Table 1 describes key implications when each dimension of character is present or absent in organisations.

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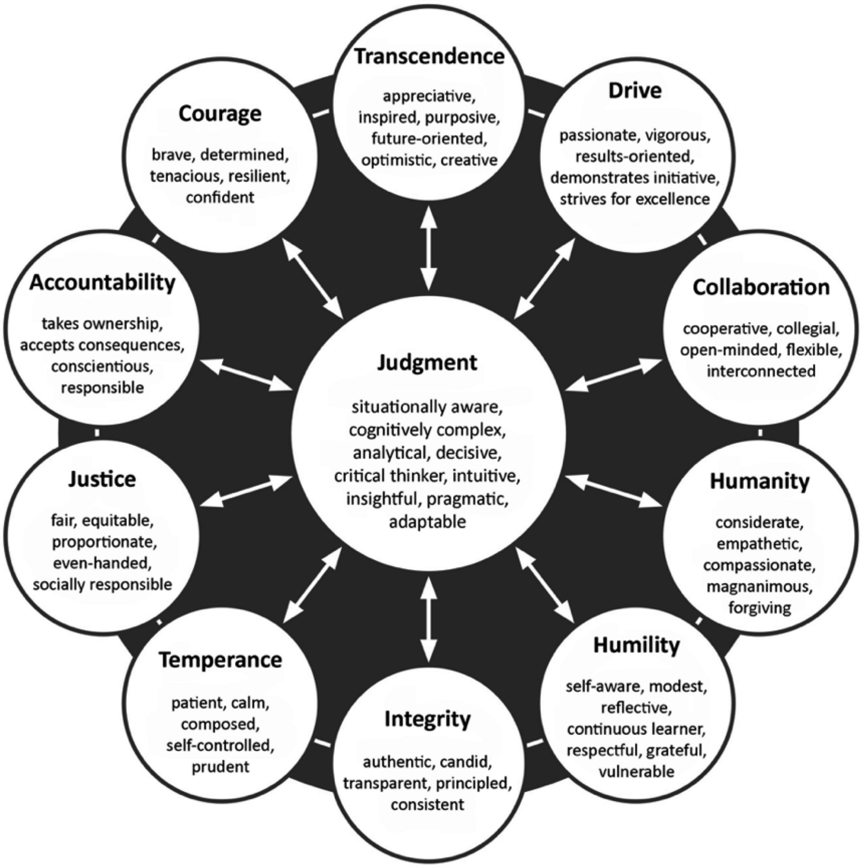
28 Mary Crossan (Ivey), Daina Mazutis (IMD), Jeffrey Gandz (Ivey) and Gerard Seijts (Ivey), Developing Leadership Character in Business Programs. (2013). This article was awarded the prestigious Academy of Management Learning and Education's Article of the Year.

29 Jeffrey Gandz, Mary Crossan, Gerald Seijts and Carol Stephenson (with research assistance from Daina Mazutis), *Leadership on Trial: A Manifesto for Leadership Development* (2010). See also Appendix 1.

30 Mary Crossan (Ivey), Alyson Byrne (MUN), Gerald Seijts (Ivey), Mark Reno (Ivey), Lucas Monzani (Ivey/Plymouth) and Jeffrey Gandz (Ivey), 'Toward a Framework of Leader Character in Organizations', (2017) *Journal of Management Studies*.

Figure 1: Leader Character Framework



All dimensions can become vices in excess or deficiency. Excess arises in cases where any one or more of the dimensions are overdeveloped or dominant and others are underdeveloped or absent. For example, a high degree of Integrity with low Humility and Humanity results in the type of leader who is certainly authentic, but ego-driven and self-absorbed and makes decisions that are self-serving instead of those that take into account broader interests. Humanity that is unaccompanied by Courage or Drive leaves leaders with a great deal of empathy but limited in their capacity to exercise it, resulting in deferred decision-making. A high level of Drive without corresponding capacity for Temperance risks reckless decisions. This lack of balance and integration between character dimensions is analogous to having a sports car with a highly tuned, powerful engine but a poor braking or suspension system.

Table 1: Impact of character dimensions on organisations

	Present	Absent
Courage	– Decisions are made in spite of uncertainty – There is opposition to bad decisions – Innovation thrives	– There is agreement with poor decisions – Satisficing rather than maximising is the norm – Moral muteness prevails
Drive	– There is sustained momentum around focused priorities and high productivity	– There is widespread lethargy and low productivity
Collaboration	– Effective teamwork enhances productivity – There is diversity in teams that contributes to innovation, understanding and appreciation for others' ideas	– An 'every man for himself' mentality breeds a hostile competitive climate that alienates potential allies – Lack of information-sharing leads to poor understanding of decisions, resulting in friction and conflict
Integrity	– There is trust, transparency and effective communication	– People operate from a position of self-interest and mistrust, which impairs their ability to make good business decisions
Temperance	– There is effective risk management governed by reasoned decision-making – There is thoughtful consideration (versus impulsive over-reaction) to events that impact the business	– Short-term gains dictate strategy – Desire for instant gratification trumps a more measured 'what is best over the long term' approach
Accountability	– There is ownership of issues and commitment to decisions and their execution	– There is failure to deliver results and take responsibility for poor decisions and outcomes
Justice	– There is perception of fairness that fosters trust – People go above and beyond what is required	– Inequities exist that erode trust – Widespread favouritism and nepotism exist
Humility	– There is a willingness to identify and discuss mistakes – The organisation supports continuous learning	– Interactions are ruled by arrogance and overconfidence – Problems and projects are approached with complacency
Humanity	– There is a deep understanding of what is important to stakeholders that fosters unique insights and competitive advantage	– There is a failure to acknowledge critical social implications of decisions and actions
Transcendence	– There is commitment to excellence – There is clarity on superordinate goals and a focus on big picture thinking – Inspiration motivates innovation	– Strategy is dictated by narrow goals and objectives – There is failure to acknowledge, appreciate or strive for excellence – People are not inspired to create and contribute
Judgement	– There is recognition of key issues relevant to situations – Decisions are predicated on excellent understanding, analysis and insight	– Lack of comprehensive and balanced assessment of issues leads to poor decisions, confusion and resistance to change

Unfortunately, many financial institutions (and other organisations as well) have inappropriately emphasised and encouraged some dimensions relative to others, creating a culture that overweights and rewards dimensions such as

Drive and Courage and underweights dimensions such as Temperance and Humility. This creates a context for decision-making in which Judgement is impaired.

A fully developed character, in which all dimensions are present and none dominates, is essential for sustained excellence as it provides the foundation that executives need to make sound judgements in difficult or challenging situations over extended periods of time.

Such character strength enables leaders to resist the pressures that can undermine judgement, whether they be compensation practices that reward inappropriate behaviours or basic psychological pressures that make it difficult for individuals to take actions that may challenge current approaches. The organisation, industry and societal cultures (barrels) within which individuals operate both define and challenge Judgement. Speaking at a convention for fraud examiners, Andrew Fastow, the former CFO of Enron, stated: 'Accounting rules and regulations and securities laws and regulation are vague… They're complex… What I did at Enron and what we tended to do as a company [was] to view that complexity, that vagueness… not as a problem, but as an opportunity'. The only question was 'do the rules allow it – or do the rules allow an interpretation that will allow it?' Fastow insisted he got approval for every single deal – from lawyers, accountants, management and directors – yet noted that Enron is still considered 'the largest accounting fraud in history'. He asked rhetorically: 'How can it be that you get approvals… and it's still fraud?'[31]

Consider that rules and regulations are often interpreted as defining 'how the game should be played' and people are often rewarded for creative application of the rules. Fastow claimed he should actually have been called the 'Chief Loop-Hole Officer'.[32] The Enron example illustrates the problems that arise from poor decision-making when operating within the letter of the law rather than the spirit of the law. The focus turns to 'creative application of the rules' for personal gain rather than exercising the judgement required to understand the spirit of the law and take actions accordingly.

In addition, rules and regulations typically seek to prevent negative performance outcomes, while values and ethics tend to define expectations. However, they are insufficient to develop the strength of character and resulting judgement that withstands the many forces that undermine sustained excellence. Forces that typically undermine sustained excellence are basic psychological and social forces, such as social comparison, bystander effect, money priming, groupthink and conformity. Compensation and

31 Peter Elkind, 'The Confessions of Andy Fastow' *Fortune.com* (1 July 2013).

32 Tracy Alloway, 'Here's a Simple Lesson in Ethics From the Former CFO of Enron' *Bloomberg.com* (2 July 2015).

other rewards are often quite transactional and focused solely on results without regard for the quality of the results and the impact that specific results can have on sustainability. Unfortunately, many 'results' have toxic elements or 'ticking time bombs' buried within them that go undetected for long periods of time as evidenced in many financial scandals. The authors assert that while currently there are few ways to test the quality of the results, deficiencies in character that produce poor judgements are usually implicated. Furthermore, where organisations seek to develop strength of character and its associated culture, it is less likely that those who habitually operate in the lower performance part of the curve will go undetected as they will be more clearly identifiable as outliers (ie, 'bad apples') and be forced to either modify their behaviour or exit the organisation.

Taken together, the implications for the financial services industry are significant. First, character needs to be elevated alongside competence to avert negative substandard behaviour and reap the benefits of superior performance through enhanced judgement. This is an important pivot away from misconduct viewed as associated with being a good or bad person, but rather as judgement foundational for sustained excellence. Second, many organisations (such as the Enron example cited earlier) have fallen into the trap of overweighting some dimensions and underweighting others, leading to toxic cultures that undermine judgement. The dimensions of character need to work together to support judgement, which acts like an air traffic controller drawing on the dimensions as needed.

Implementing the Leader Character Framework

Character can be defined using the language of the Leader Character Framework. We present the Leader Character Insight Assessment (LCIA), a tool whereby it becomes possible validly and reliably to assess the Leader Character of an individual. The Leader Character Framework also provides the basis to interpret, organise and evaluate the results from more traditional techniques, such as biodata, deep reference checking and interviews.

Organisations are already assessing character (in the judgement sense) using the LCIA offered through Sigma Assessment.[33] It is a reliable and valid survey-based instrument that can be used in self-assessment or 360 format. The results enable individuals and organisations to identify areas of development. Since the Leader Character Framework is behaviourally based, it can be used to select, develop, reward and promote on the basis of character and judgement. Elevating character alongside competence for

33 See Appendix 2 for sample LCIA report excerpts.

sustained excellence is in the best interest of organisations and the regulators who provide stewardship.

Character is often (mis)understood as being similar to personality or physical traits, and therefore not subject to meaningful change ('you either have it or you don't'). However, research suggests otherwise for the following reasons:

- A person's character-driven behaviours change often due to the effects of context or neglect, sometimes because of some intense, crucible experiences, and other times as a result of intervention by others. It can change for the worse; it can also change for the better.
- Character is 'a habit of being'. Change the habit and character change will follow.

There is a substantial body of anecdotal and academic literature that supports the intentional and sustainable development of character. This article discusses three primary approaches to implementing programmes to develop character: feedback and performance management, self-management and stretching, and behavioural modelling and mentoring.[34]

Feedback and performance management

Performance management is an integral part of a comprehensive human resources (HR) system, and feedback is an essential component of this process. The value of the Leader Character Framework and LCIA is that they provide clear language to identify and measure key behaviours that can be used for feedback. In addition, the focus of the feedback is on enhancing individual performance, not providing value judgements, thereby creating a positive, supportive context for the discussion. Specifically, organisations can incorporate Leader Character and the LCIA into: job or position profiles; leadership assessment; promotion decisions; and conspicuous recognition of character dimensions in communications about key appointments and promotions. A number of organisations, such as Aecon, General Dynamics Land Systems (Canada) and OMERS, have been successfully weaving the LCIA and Leader Character concepts into their HR practices to support performance management and leadership development. FIs, such as TD Bank Group and others, address many of the character dimensions and elements in their leadership profiles and assessments. However, the risk is that some organisations emphasise some dimensions and not others, thereby falling into the serious trap that what they thought were virtues have become

34 This section is a summary of elements drawn from the academic paper: Gerard Seijts (Ivey), Mary Crossan (Ivey) and Erica Carleton (Edwards), 'Embedding Leader Character into HR Practices to Achieve Sustained Excellence', (in press, 2017) *Organization Dynamics.*

vices that undermine performance because they become unbalanced by the character dimensions that have been excluded. Abbreviating the character dimensions to simplify the framework or shorten assessment instruments virtually guarantees this imbalance.

Self-management and stretching

Individuals can take ownership of their character development through self-management and stretch assignments. The Leader Character Framework and LCIA provide a common language to provide each individual with a unique insight into his or her own character, and a reliable guide to leverage strengths and address weaknesses. Each person can intentionally pursue certain assignments or activities in order to develop particular character dimensions, and be more mindful when reflecting upon and interpreting the resultant experiences. This enhanced level of self-awareness is critical to sound judgement and decision-making, in particular in the routinely stressful environments experienced by the leadership of large and complex financial institutions.

Behavioural modelling and mentoring

It is the role of the organisation's HR department to ensure that its employees, in particular its leaders, have access to the necessary educational and human resources to ensure that the lessons learned in these stretch assignments and activities are fully appreciated and absorbed by the individual. Experience suggests that these initiatives will only gain traction if the senior leadership visibly commits to their utilisation and models the appropriate behaviours. The Leader Character Framework, combined with the results of the LCIA, provides individual, targeted character dimensions for focused behaviour modelling. The LCIA also provides a tool for the individual to reassess and measure his or her progress, and suggest new areas for development.

The process of embedding needs considerable and conscientious forethought in order to properly implement Leader Character and avoid organisational disharmony and/or harm. For example, it would be prejudicial to the implementation of the Leader Character Framework if middle management were to judge that the board, chief executive or executive management were disingenuous in their support for it, hypocritical in its implementation or not personally striving to achieve character development in their day-to-day actions.

However, the process of embedding Leader Character in an organisation need not be a high-profile, attention-seeking, dramatic event that disrupts existing HR frameworks, models and practices. Rather the process for successfully embedding Leader Character in an organisation can be much the same as for an individual: a patient, intentional and disciplined process integrated into existing objectives and activitities. Importantly, character should not be treated as a subset of an organisation's existing competency-based HR programmes, but rather as a valuable, seperate and equal partner that seeks to leverage and empower these existing programmes. In some cases, certain aspects of an organisation's existing leadership framework (eg Integrity) are best transferred to the Leader Character programme, where that specific dimension can be assessed and developed more effectively in tandem with the other dimensions.

Leaders, on their own initiative, perhaps encouraged by regulators, can take advantage of many leverage points to instil character in their organisational cultures. They can use the examples of lack of character in the published experiences of others (Wells Fargo, Volkswagen, Enron, HSBC and others referenced in this article) to answer the question: 'Could this happen here?' They could build the link to character in their internal training and development programmes that deal with risk management (credit, market, operational and reputational, and the 'Three Lines of Defence' risk management framework commonly employed in the industry) as well as wealth management and investor advice.

Implications and application of a character-based approach for regulators

Regulators have long been struggling to pin down the persistent and elusive issues associated with culture, behaviour and, especially, misconduct in the financial industry. In October 2016, the Federal Reserve Bank of New York held its third annual conference on reforming culture and behaviour in the financial services industry. The main message has remained consistent: 'It is ultimately the industry's responsibility to change its culture and behaviours'.[35]

There is not universal agreement that culture and behaviour are clearly within a regulator's remit. Some industry participants believe that regulators 'should be concerned only with outcomes… that questioning culture is too intrusive, or that regulators lack the expertise to make informed judgements on a bank's culture'.[36] However, there is arguably a consensus that culture, as evidenced through observable behaviour, is an appropriate factor for risk management and that supervisory assessments might be improved by examining behaviours at financial institutions. A leading example is De

35 Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue, Summary Notes, Federal Reserve Bank of New York, 9 November 2016, p1.

36 *Ibid* 9.

Nederlandsche Bank (DNB), the first national banking supervisor to consider culture and behaviour as early stage risk factors subject to supervision. DNB's in-person examinations focused on 'leadership, decision-making and communication and also addressed the group dynamics, behavioural patterns and mind-sets of executive and pension fund boards'.[37] DNB uses surveys, interviews and attendance at board meetings to develop its views on an institution's culture and behaviour, and to formulate specific findings.

Whether individuals or groups in organisations engage in misconduct is highly influenced by the culture – the system of shared values and beliefs – within those organisations. Those cultures are themselves shaped and moulded by the character of organisational leaders who, through their behaviours, decisions and judgements, set examples for others, and influence organisational policies, practices, processes and systems. If regulators actually want compliance, they must address character, before character deficiencies lead to poor decisions, judgements and ultimately risk of loss.

This article proposes that regulators ask a number of questions at the board, senior executive and lower levels in organisations and assess the quality of the responses they get:

- Does the organisation attach importance to the character of its leadership teams? If not, why not?
- If yes, how does the organisation define, assess and develop this character? To what extent have these initiatives or programmes demonstrated improvement with respect to these objectives?
- Do the organisation's code of conduct, mission, vision and value statements, leadership profiles and mandates emphasise the importance of character? In what ways? Is there explicit or implicit overweighting of some dimensions and underweighting of others?
- Does the organisation incorporate character into its decisions related to recruitment, development, compensation, promotion and termination?

Regulators could assess an organisation's responses to each of these on a (four) point scale:

- 0: Organisation does not consider character important to individual or organisational performance.
- 1: Organisation considers character *important* to individual and organisational performance, incorporates this belief into various organisational materials (eg, value statements), but otherwise does not incorporate into its human resources policies, procedures and processes.

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37 Jakob de Haan, Wijnand Nuijts and Mirea Raaijmakers, 'Supervising culture and behavior at financial institutions: The experience of De Nederlandsche Bank' *VOX CEPR's Policy Portal* (5 November 2015).

- 2: Organisation considers character important to individual and organisational performance, incorporates this belief into various organisational materials (eg, value statements) and incorporates – on a largely *qualitative* basis – into its human resources policies, procedures and processes.
- 3: Organisation considers character important to individual and organisational performance, incorporates this belief into various organisational materials (eg, value statements) and incorporates – on a qualitative *and quantitative* basis – into its human resources policies, procedures and processes.

If regulators are going to ask these questions, then legal advisers, whether in-house counsel or external, must ensure that their clients are prepared to address them. In most financial institutions, policies, procedures, performance management systems and training programmes get legal sign-off. If they don't currently address character issues, they should, and legal counsel should be fully engaged in making this happen.

In the authors' view the most important outcome of this approach will be to reframe the discussion away from questionable morality and poor behaviour to a non-threatening, dispassionate and positive dialogue on the nature of decision-making and judgement required for sustained excellence of both the organisation and its leadership.

Conclusions

This article concludes its discussion with three main points:

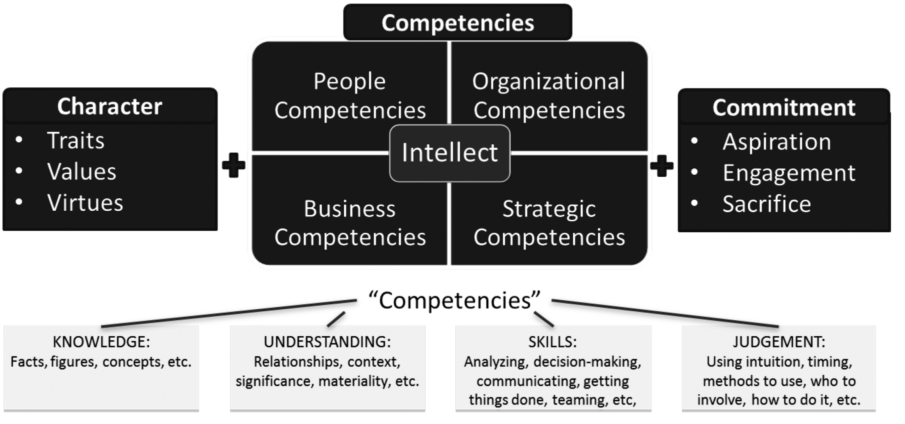
1. *The continuing misconduct in the financial services industry indicates that the approaches and remedies employed to date have met with limited success.* It is also clear that the financial services sector is too important to the overall functioning of the global economy for this misconduct to persist. Indeed, key regulatory bodies have signalled that the status quo is simply not acceptable. New approaches, perspectives and initiatives are required.
2. *Reframing misconduct in the financial services sector to add character-driven judgement to the moral issue represents a more complete formulation of the problem.* This reframing has three very significant practical advantages. First, formulating the issue as primarily one of judgement does not meet the same emotional resistance that a 'moral' framing will encounter and allows for a strong alignment of interests among all stakeholders. Second, improved judgement, decision-making and performance that results from a properly implemented Leader Character programme will allow the programme to take its place at the core of corporate strategy, leading to sustained and permanent

change. Third, improved character-based judgement will have a positive impact on the context and culture within which decisions are made, fully activating the many measures already put into place, while further improving sustainability and limiting the risk of an incorrigible individual and/or cultural regression.

3. *Embracing and implementing Leader Character represents an opportunity and challenge to the financial services sector*. Significant sustainable advantages can potentially accrue to the 'first movers' for the leaders in financial institutions who instinctively understand the value that character-based judgement provides in any enterprise that aspires to excellence. Although the challenges of implementing Leader Character may at times appear formidable, the costs and risks of inaction (or simply staying the course) in the current environment are no longer acceptable. The authors strongly encourage leadership across the financial services sector to consider plans, approaches and initiatives directed at embedding leader-character-based judgement as a core element for the long-term prosperity of their organisations. Organisations can start wherever there is a strategic imperative, whether it be recruiting, onboarding, leadership development, compliance, organisational transformation or the myriad diverse agendas organisations face. All that needs to be done is to consider how character can fundamentally shape the agenda.

Warren Buffet has been quoted as saying: 'Somebody once said that in looking for people to hire, you look for three qualities: integrity, intelligence, and energy. And if you don't have the first, the other two will kill you'. This article uses somewhat different language, but the idea is much the same. It doesn't matter how much competency exists, how highly motivated and committed to achieve results the people are, it is character-infused judgement that harnesses competency and commitment to produce sustainable excellence while simultaneously avoiding harmful or even catastrophic outcomes. Developing character and the judgement associated with it provides a practical and meaningful approach to addressing misconduct while also strengthening sustainable organisational performance.

Appendix 1: The three Cs of leadership



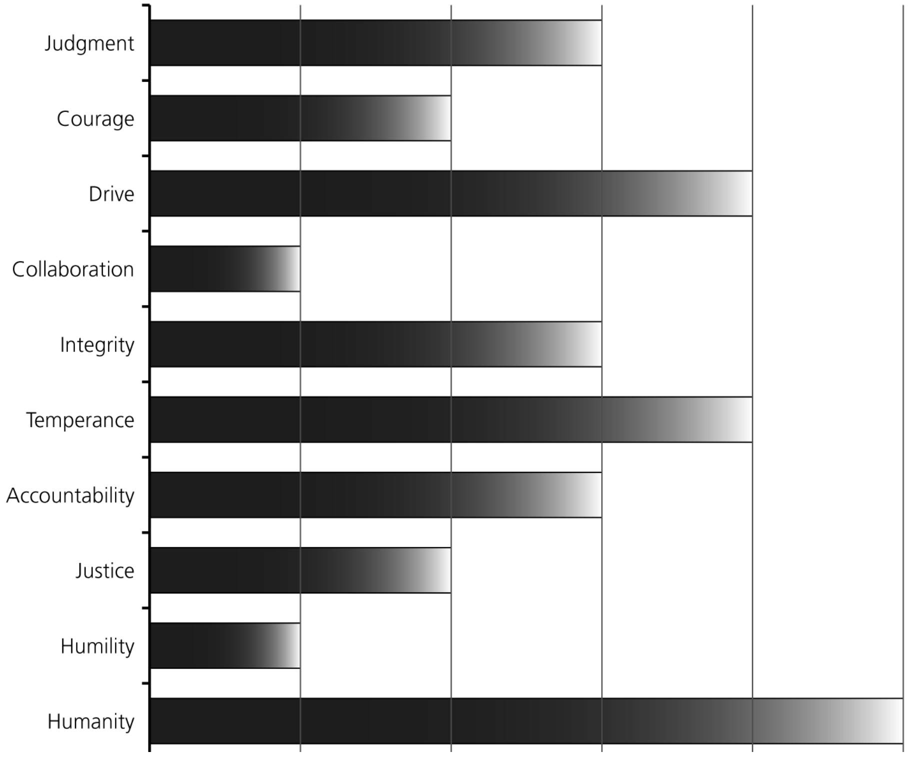
Gandz, J., Crossan, M., Seijts, G. and Stephenson, C. (2010). Leadership on trial: A manifesto for leadership development. London, Ontario: Ivey Business School.

Appendix 2a: Sample LCIA Report – Summary

LCIA Results Overview

Dimension Scores

In responding to the LCIA items you were asked to identify how likely you would be to engage in various behaviours that reflect the character dimensions and elements described in this report. You responded using the following scale:
1=Extremely Unlikely, 2=Unlikely, 3=Unsure, 4=Likely, 5=Extremely Likely.
The graph below shows your score on each character dimension.



Appendix 2b: Sample LCIA Report – Judgement

Judgment

Makes sound decisions in a timely manner based on relevant information and critical analysis of facts. Appreciates the broader context when reaching decisions. Shows flexibility when confronted with new information or situations. Has an implicity sense of the best way to proceed. Can see into the heart of challenging issues. Can reason effectively in uncertain or ambiguous situations.

Elements

Situationally Aware: Demonstrates an appreciation for unique circumstances that may dictate unique approaches.
Cognitively Complex: Analyses, makes clear sense, and draws sound conclusions in uncertain, complex and ambiguous circumstances.
Analytical: Skillfully analyses and employs logical reasoning.
Decisive: Promptly makes astute, level-headed decisions. Shows clear-sighted discernment of what is required.
Critical Thinker: Applies sound analysis and logical reasoning to evaluate ideas, decisions and outcomes.
Intuitive: Understands things without an apparent need for conscious reasoning.
Insightful: Grasps the essence of situations. Sees into the heart of challenging issues.
Pragmatic: Understands, develops and implements workable solutions under varied circumstances.
Adaptable: Modifies plans, decisions and actions to adjust to new conditions.

The chart below displays your ratings for **Judgment** and its key elements.