Ethics Box 5 – Chapter 5

What About Moral Risk?

J. Zietlow

The poster boy for "moral risk," the devastating effects of unethical behavior for a company's investors, has to be Nick Leeson. This 28-year old trader violated his bank's investing rules while secretly placing huge bets on the direction of the Japanese stock market—and when those bets proved to be wrong, the $1.24 billion dollar losses resulted in the demise of the centuries-old Barings Bank. More than any other single episode in world financial history, Mr. Leeson's misdeeds proved the importance of character in the financial industry. Forty-one percent of surveyed Chief Financial Officers admit ethical problems in their organizations (we suspect self-reported percents to be low), and forty-eight percent of surveyed employees admit to engaging in unethical practices such as cheating on expense accounts or forging signatures. One of the main reasons for accounting fraud was the pressure to "hit the numbers" expected by some security analysts on Wall Street – and 47% of CFOs surveyed in 2004 continue to feel pressure from the CEOs to use aggressive accounting to "make the numbers work", according to *CFO Magazine* – and only 38% say they are under less pressure to make the numbers agree with targets. We are reminded again that shareholder wealth maximization has to be ethically constrained. The good news is that the same *CFO* survey finds the CFOs going up against their CEOs and improving ethical standards in their departments, thanks to the 2002 Sarbanes-Oxley law.

What to do to instill and maintain ethical corporate practices? Start by building awareness through a code of ethics. Almost all Fortune 500 companies and about half of all companies have an ethics code spelling out general principles of right and wrong conduct. Companies such as Texas Instruments have gone into specifics, because ethical codes are often faulted for being too vague and abstract.

But the Leeson saga underscores the difficulty of dealing with the "moral hazard" problem, when the consequences of an individual's actions are largely borne by others. John Boatright argues in his book Ethics in Finance that the best antidote is to attract loyal, hardworking employees (although, clearly, loyalty can be used as an excuse for doing wrong). Ethicists Rae and Wong tell us that debating issues is fruitless if we continue to ignore the character traits that empower people for moral behavior. More companies are administering honesty tests prior to hiring new workers. Ethical organizations reveal their commitments through talking about ethical values periodically, weeding out employees that do not share those values before they can harm the company's reputation or culture, including ethics in mid-level managers' required training (as at Proctor & Gamble), modeling it throughout top management and the board (termed "tone at the top," especially notable at Johnson & Johnson), promoting openness for employees with concerns (whistle-blowing provision and protection is now mandated by Sarbanes-Oxley legislation), having a person carrying the role of ethics director (as is now done at Boeing, as dictated by a key customer, the U.S. Air Force, subsequent to ethical problems), and evaluating leaders' ethics in performance reviews (as at Merck & Co.).

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