

The (ir)relevance of integrity in organizations

How to “align” management payment and performances?

Corporate scandals seem to indicate that the corporate sector has been infiltrated by concealed malpractice, compulsory greed and compelling distrust. At present, the corporate world goes through another crisis of confidence. The capitalist market system is at its heart about trust. The sins of arrogance, greed, untrustworthiness and callousness are hard to forgive claims the Chairman of HSBC, Stephen Green in his reflective book *Good Value* (2009).

It looks like that corporate governance when based and driven by the formal principles of monitoring and sanctioning only tends to worsen the very problem it is designed to resolve. The present debate about exuberant executive compensation packages will likely remain misguided as long as the traditional agency theory – stipulating that the only business objective is to “maximize” shareholder value – is the prevailing model by which firms are governed and managed. Focusing on *extrinsic motivations* of monetary compensation to reward managers and experts for high(er) performances to create more shareholder value, may not necessary lead to the expected results. Even Michael Jensen, one of the most staunch promoters of the agency model, admits that the existing system of stock options compensation has proven to be “managerial heroin”, encouraging a focus on short-term highs with destructive long term consequences (in *The Economist*, 16 November 2002: 66). Indeed, the current corporate and financial crisis that almost brought the global financial system to a standstill last year was likely caused by credit-giving malpractices, greed initiated by sophisticated financial instruments and a lack of sensible risk management.

Corporate governance has established institutionalized mechanisms that counteract the misuse of power by management in the form of intensive monitoring and sanctioning by the board, by paying their top talent according to performance, and by having corporate control procedures in place in case of hostile takeovers. However, those traditional corporate governance mechanisms are not very effective when dealing with intangible value and other shared resources such as corporate reputation or corporate ecological footprint; they can even be counter-effective because the suggestion that an increase in payment to its leadership increases the effort may not be true after all. When the penalty for environmental pollution or violation of codes of

conduct is perceived to be very controlling and intrusive, managers and employees are no longer [so] motivated to protect the environment or adhere to social norms and moral values for intrinsic reasons [to do “the right thing”]. The firm is turned into a compliance-driven organization where actions beyond compliance would not be “remunerated” anyway; every action is turned into a strictly priced activity or formalized legal transaction, often demolishing loyalty and goodwill.

Instead of stricter monitoring, more regulations and heavier sanctioning within organizations, or instead of focusing on extrinsic high pecuniary motivating rewards, the author suggests to re-emphasize the importance of *corporate virtue of integrity* in organizations as an effective way to resolve corporate externalities, potential free-riding or possible reputation risks – commonly described as “social dilemmas” of shared common resources within organizations. Integrity and other “common good” factors function as informal social control mechanisms in organizations, as the 2009 Economics Nobel laureate Eleanor Ostrom argues.

Indeed, despite the overt and justifiable pressures for economic performance, ethical and ecological sensitivity cannot and should not be ignored. Hence why it may be worth considering to emphasize employees’ and management’s *intrinsic motivations* to contribute to sustainable organizational value. Empirical evidence suggests that stricter formal control and the threat of negative sanctions tend to decrease loyalty to the firm (as convincingly analyzed in a study by M. Osterloh and B.S. Frey, 2004, *Corporate Governance for Crooks?*). Intrinsically motivated honesty and trustworthiness for instance is often undermined by the presumption that managers act solely in the interests of the shareholders if they are paid enough. Moreover, employees’ honesty is in jeopardy if they see that their superiors feather their own nests at the expense of the firm and the employees. The conventional agency-based assumption has overlooked the fact that conditioning on pecuniary compensation only reduces the voluntary commitment to the firm and its shareholders. In management and economic literature such *crowding-out effect* implies that tangible and monetary rewards often undermine intrinsic motivations.

The perceived positive image of integrity as good reputation may have an empowering influence on the functioning of the organization. The danger, however, exists that integrity may become the latest business buzz word to justify some utilitarian and often fashionable ethical discourse – not necessarily real ethical behavior – in an organization. Managers with a reputation of strong integrity have a clear sense of

purpose, grounded in consciously selected ethical priorities that allow them to face new challenges with creativity and initiative. However, managers do not need ethics preached to them. Integrity is not just a self-contained trait of virtuous character, but rather an interactive attitude in relationship with others that increases self-understanding and awareness of one's ideals and objectives as well as the threats to those. In this interaction with others, integrity is directly tied to mutual trust and thus less dependent on formal bureaucratic rules and authority-obedience relationships. Integrity discerns what is morally appropriate and what is not, implicitly implying consideration of others with whom one lives in a community or works in an organization. Integrity carries a relational component that is too often ignored. Organizational integrity becomes a social virtue which emphasizes a connectedness with a larger purpose. "Having integrity" is quite misleading as if integrity were a mere possession. Integrity is not so much a character trait as it is a sophisticated reflective constant state of awareness that results in an attitude that encompasses moral creativity and ecological awareness.

Nonetheless, moral stress is aggravated by a sense of isolation as result of absence of organizational structures. The ability of leadership to retain their integrity will depend on the way in which ethical principles are exercised in sustaining the organizational form of best ethical and good governance practices. Especially in crises, the process of envisioning and communicating these principles is as important as the content of the principles themselves. The "how" you do is sometimes more important than "what" you do. In those "defining moments" of crisis or in facing daunting leadership challenges genuine commitments are revealed and the strength of the leader's ideals and moral values are tested. Integrity demands the capacity to work and live within the inescapable tension between the "virtue" of organizational integrity and a savvy *virtu* of commercial shrewdness in an unforgiving economic-political world.

The appeal of integrity used in public relations campaigns and other reputation beauty contests as "most admired companies" may become counter-productive and irrelevant if those expectations do not match deliverables. Emphasizing the intrinsic value of integrity, however, allows organizations to develop a genuine "interest" that cares for its customers, employees, suppliers and the broader environment in which it operates. Ultimately, such a *fiduciary care* will serve the corporate leadership's *fiduciary duty* to create and enhance shareholder value.

Integrity as good reputation proves to be "useful" for organizations as an insurance policy against reputational risk. Moreover, while integrity likely increases the intangible

value of the organization, it also incorporates some intrinsic value worth pursuing for its own sake. A trustworthy and truthful Chief Executive Officer could also be considered a 'Chief Ethics Officer' who leads his organization in a more appropriate and sustainable way, while enhancing its total shareholder value. More than ever, there is a need for integrity in organizations – consciously deliberating, pursuing and balancing economic goals with ethical and ecological principles – as living examples to restore confidence in organizations. Organizations and corporate governance mechanisms should *integrate [moral and environmental] values with [commercial] value*, encouraging a crowding-in effect of integrity rather than emphasizing the crowding-out effect of pecuniary rewards. Values really matter to achieve commercial value.

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Peter Verhezen is currently a Visiting Scholar at the University of Melbourne (Australia), teaching and performing research in the field of Corporate Governance in International Business. Prior to this appointment, he was a management consultant and entrepreneur for more than 25 years, mainly in Asia. He still advises organizations on Integrated Risk Strategies, Business Ethics and Good Governance Practices, among which the Great Union Oil Investments Ltd, a recently established energy company in Hong Kong.

He obtained a Master's in Applied Economics (International Relations) from Antwerp University (Belgium), an MBA (Finance) from Leuven Vlerick Business School/Chicago Business School and a Master's and PhD in Philosophy from the University of Leuven (Belgium).

