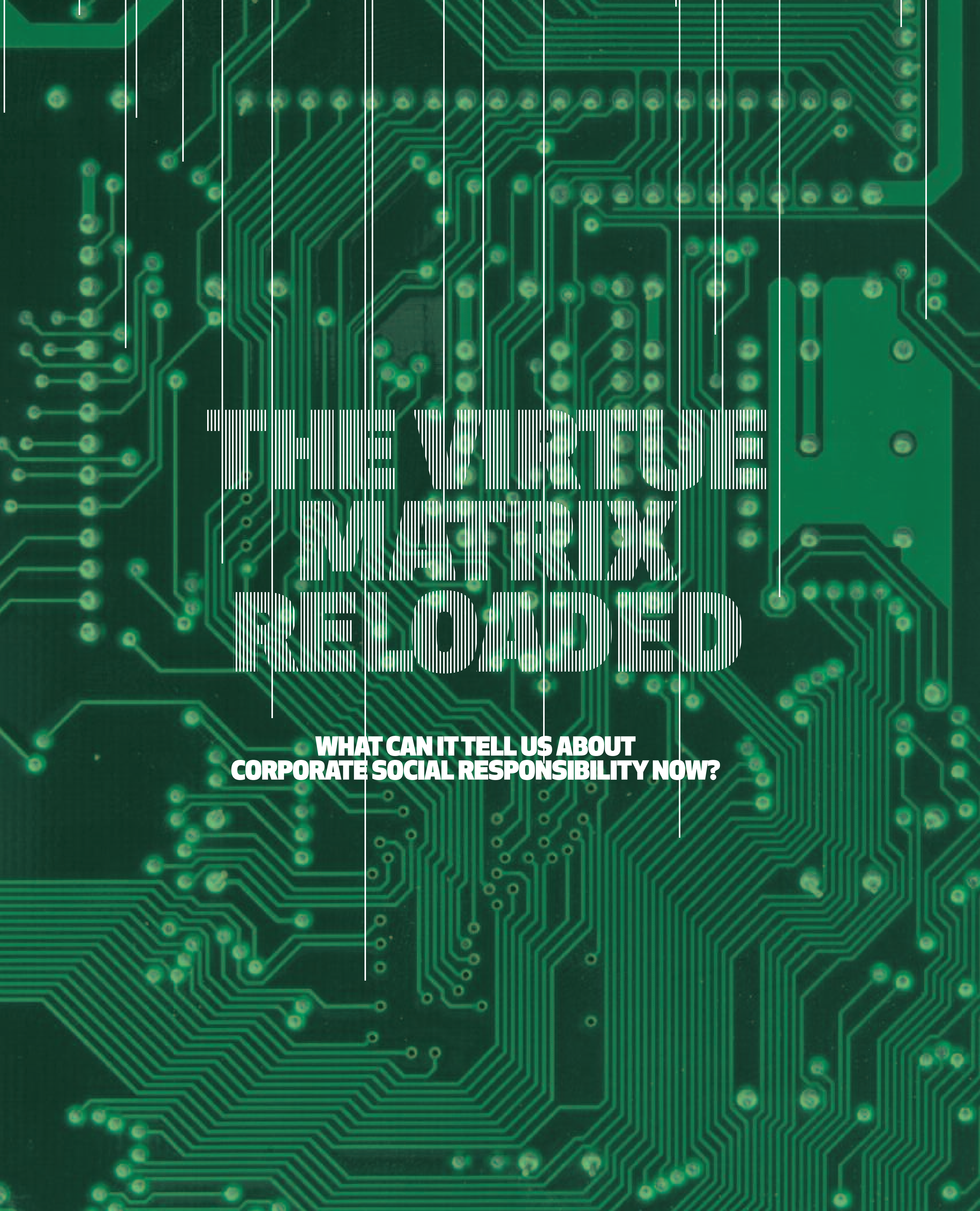


THE VIRTUE MATRIX RELOADED

WHAT CAN IT TELL US ABOUT CORPORATE SOCIAL RESPONSIBILITY NOW?

by Roger Martin, Alison Kemper and Jennifer Riel

'CSR' has long been poorly defined, without widely accepted, actionable tools. The Virtue Matrix aims to clear the muddy waters.

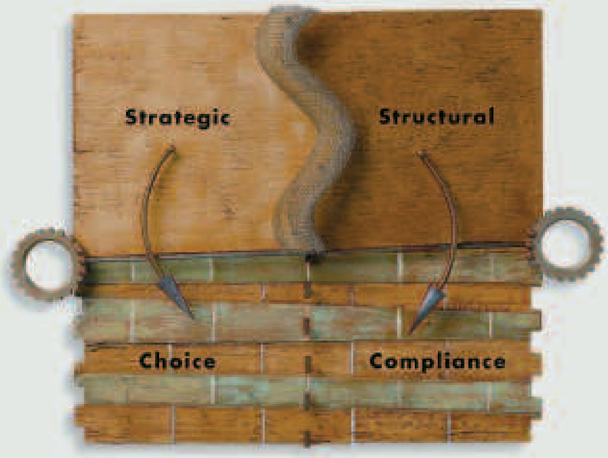
TAKE A SEAT IN ANY BOARDROOM or MBA classroom and eventually, the underlying mantra will emerge: "the business of business is business." So said **Milton Friedman** in 1960. And so it has been.

In sum, Friedman and his Shareholder Value Theory acolytes argued that a company's sole responsibility is to maximize the return to its shareholders. The company holds no additional responsibility to society at large; instead, its goal is to drive value – as measured by stock price and dividends – ever upwards. This pervasive view has been inculcated in business schools and enacted in the real world, informing everything from financial market regulations to stock incentive plans. Unfortunately, it is based on a shallow line of reasoning that has also led to problematic social, environmental and economic outcomes, blinding corporations to alternative views and creating ethical minefields for executives.

The 'profits-at-any-cost' model led **JP Morgan** to pioneer credit derivatives as a new money-making tool in the 1990s. So far, so good – credit derivatives held the promise of helping financial companies more effectively manage the risk of their portfolios. But before long – under pressure from U.S. regulators to insure the risk associated with these credit vehicles – JP Morgan began to look around for the least-regulated jurisdiction in which to insure them and to find a partner not bound by the strict reserve capital requirements faced by U.S. banks.

At the same time, Shareholder Value Theory led one of JP Morgan's biggest customers – insurance giant **AIG** – to go after the significant financial rewards associated with insuring those

The Virtue Matrix Figure One



credit derivatives. They hired traders who had once worked for junk-bond king **Michael Milken** and set them up in London, where the regulatory structures were less restrictive than in New York and where the regulators were even less interested in overseeing the new financial behemoth under their noses. Through artful strategy, AIG managed to set-up its Financial Products division to be largely free of any oversight at all: it was regulated not by the **SEC** but by the tiny **U.S. Office for Thrift Supervision**, which had virtually no expertise in the credit default swap arena.

All of this makes sense in light of Friedman's doctrine. Regulations, after all, impede profits, so AIG was bound to do anything it could to skirt them, staying within the letter – if not the spirit – of the law while exposing itself and its partners to massive, little-understood risks in pursuit of massive profits. By the time the U.S. mortgage market crashed in 2008, AIG's London-based Financial Products group had entered into almost a half-trillion dollars worth of credit default swap agreements. The massive losses associated with its defaults would lead to the largest government bailout in U.S. history and the worst financial crisis since the Great Depression. And it all happened in the single-minded pursuit of 'greater shareholder value.'

The Need for an Alternative Model

There is no doubt about it: Shareholder Value Theory is elegant, understandable and implementable. It is supported by an elaborate infrastructure of tools like discounted cash-flow analysis or cost-of-capital calculations, and metrics like earnings-per-share growth or total shareholder return. Despite the cautionary tales, it shows little sign of loosening its grip on the C-suite, and part of the reason is that we have lacked a viable alternative: there has been no widely-accepted theoretical model of pro-social corporate decision making, nor a set of tools to do business differently.

It is not enough for us to point out the flaws of Shareholder Value Theory and say "we can do better," or to ask executives to avoid the minefields and admonish them to "do good!" Nor is it enough to have MBA students adopt a Professional Oath of Honour, as our friends at the Thunderbird School have done. Laudable as these impulses are, they assume that people can change their behaviour just by wanting to do so. They ignore the possibility that business people are already being as good as they know how to be, given the models and tools at their disposal. No, business people will only act differently if they are provided with a framework every bit as clear and robust as Shareholder Value Theory and real tools for thinking about corporate social responsibility.

What business leaders need is a way of thinking strategically about CSR and an actionable framework for thinking about more than shareholders that leads them to act like human beings rather than self-interested agents. This was the argument laid out in "The Virtue Matrix: Calculating the Return on Corporate Responsibility" [*Harvard Business Review,* 2002.] It is time to revisit the Virtue Matrix.

The Virtue Matrix

The aim of the Virtue Matrix was to provide a concrete, actionable framework for companies to assess opportunities for socially-responsible action and create a corporate citizenship strategy.

The Matrix consists of four quadrants. The bottom two – choice and compliance – make up the *civil foundation*. The civil foundation reflects the broad norms, customs and laws that govern corporate practice. Companies either engage in these practices by choice (they choose to conform to a set of norms, without being compelled to so by government regulation) or in *compliance* (they comply because they are mandated to do so by law). In the civil foundation, actions taken do no more than meet society's existing expectations, maintaining the status quo rather than moving society forward.

Such actions align well with the interests of shareholders and the pursuit of profits. For example, in the choice quadrant, a company might choose to give money to charity to bolster its corporate reputation and vow to generate more sales to offset that charitable gift. In the compliance quadrant, a company might undertake specific activities designed to keep itself on the right side of the law – say, by instituting information seminars on sexual harassment, or following worker-safety regulations to prevent costly lawsuits and reputational damage. These forms of CSR explicitly serve the purpose of enhancing shareholder value and as such, can be described as *instrumental*.

But what of the kind of socially-responsible activity that business leaders initiate regardless of its effect on shareholders – actions that a company undertakes because it sees those actions, first and foremost, as 'morally right'? The motivation for these kinds of actions is not so much instrumental as *intrinsic* – that is, executives engage in this conduct for its own sake, rather than specifically to increase shareholder value. The critical distinction when it comes to intrinsically-motivated behaviour is that some actions can turn out to benefit society *and* increase shareholder value, while others benefit society but hurt shareholder value. This distinction is the dividing line between the top two quadrants of the Matrix – the *strategic frontier* and the *structural frontier*.

At top left, the strategic frontier represents individual action – in which a single firm engages in socially-responsible behaviour that ends up benefiting both society and shareholders. A classic example is **The Body Shop**, which offered an environmentally- and animal-friendly approach to personal care and beauty products. The approach, and the brand, took off with consumers in a way that both made the world a better place and generated hugely positive returns for shareholders.

In the top right box, the structural frontier, actions benefit society but hurt shareholder value. In this quadrant, initiatives taken by a single company tend not to last, because the cost to shareholders is too great. Imagine that the leaders of a single firm decide that spending resources to reduce greenhouse gases is the morally right thing to do. The firm invests in its new green initiative, but it gets no reward from customers for doing so. In the process, the firm becomes less cost competitive and is forced either to stop the initiative or go out of business. Economists would say that in the structural frontier, the externalities are too great: actors outside the company garner the lion's share, if not all, of the benefits. In the greenhouse gas example, the world benefits; shareholders lose out, and this win-lose dynamic creates a serious barrier to corporate action.

The solution within the structural frontier is collective action. If an entire industry or consortium decided to act collectively on greenhouse gas emissions, it could do so together, contributing significantly to society while avoiding huge, imbalanced costs to the shareholders of a single company.

Activities in one quadrant of the Virtue Matrix can influence the others. When activities in the strategic frontier become successful, they tend to be copied and become norms for society more generally. For example, after the success of The Body Shop, it was obvious to all beauty-care companies that being more environmentally-and animal-friendly made lots of economic sense. When successful actions take place by way of a coalition in the structural frontier, governments can ensconce the successful joint action into law. Both of these movements from the frontier have the effect of ratcheting up the civil foundation, strengthening it for all of society.

Alternatively, firms and collectives can chip away at the civil foundation, advocating for less government regulation or moving operations to jurisdictions with lower standards of behaviour. AIG, **Merrill Lynch** and the thousands of mortgage brokers who encouraged borrowers to take out subprime mortgages all chipped away at the civil foundation, to our collective detriment.

In the right hands, the Virtue Matrix provides the tools to become a truly exemplary corporate citizen. **RBC Financial** – one of the first companies to actively employ the Virtue Matrix in developing its CSR strategy – worked with us on the effort. In our work together, it became clear that, as a federally-chartered Canadian bank, RBC already met exacting compliance requirements. As a long-time civic leader, it dominated the choice quadrant, earning accolades and loyalty for its philanthropy and community engagement. Indeed, during our consulting engagement, RBC was selected as the firm with the best CSR policies and practices *in the world*. Yet it chose to push on to develop new models of corporate citizenship.

With the enthusiastic support of Chief Operating Officer **Barb Stymiest**, RBC developed the Blue Water Project™, a bold initiative at the very edge of the strategic quadrant. In 2007, RBC began by committing $50 million over 10 years to support initiatives that foster a culture of water stewardship. This wasn't a case

INSTEAD OF STRIDING BOLDLY INTO THE STRATEGIC FRONTIER OR COLLECTIVELY INTO THE STRUCTURAL FRONTIER, FIRMS HAVE FAILED TO ACT OR HAVE CHIPPED AWAY AT THE CIVIL FOUNDATION.

of throwing money at a charitable cause and hoping customers noticed: this was RBC choosing to become distinctively identified with a critically-important issue. By using the Virtue Matrix, RBC was able to apply business logic to an environmental opportunity – using tools similar to the ones it would use to assess a new product or service. In doing so, RBC raised the bar for CSR performance by using its resources not to meet existing expectations of a big bank, but to change the trajectory of Canadians' water use. RBC has long been considered a good company. Now, it has moved the goalposts, and other firms may have to step up to the challenge.

The Virtue Matrix Today

As firms like RBC have come to embrace the Virtue Matrix as a critical tool for thinking about CSR, many others continue to cling to the tried and true path. As the financial crisis of 2008 demonstrates, there is a long way to go. In many ways, this crisis represents a crossroads for Shareholder Value Theory, CSR and the Virtue Matrix.

As we pick up the pieces of our global economic systems, it is important to ask how we should think about the Virtue Matrix now. To begin, let's look at another aspect of the 2008 crisis – the subprime mortgage meltdown. The number of subprime mortgages – mortgages offered to individuals with poor credit history or little collateral – issued in the U.S. had grown dramatically in the five years leading up to 2008, in response to a thriving financial market for mortgage-backed securities. So long as the U.S. housing market continued to grow and workers stayed employed, the system was utterly reliable: Americans had easy access to mortgages and financial services firms had derivative products with predictable and easy returns.

Unfortunately, the system was also utterly invalid, resting on assumptions made about historical subprime mortgages and the default rates associated with them back when the banks held the mortgages themselves, and had an incentive to prevent default. The system also rested on the assumption that U.S. housing prices would continue to rise, or would at least level off slowly. Of course, as the price of oil went up, shipping and other costs grew, businesses began to fail, commuting became more expensive, suburban housing became undesirable, the housing market crashed and mortgage default rates increased dramatically. All of a sudden, those reliable mortgage-backed derivatives become toxic, and billions of dollars of value evaporated from the world's financial markets.

Many have argued that the subprime debacle was an outlier event, perpetuated by evil individuals in a blind mix of ignorance and greed, and now that it is behind us, we can clear up the mess, put in some stricter regulations and move on with our lives. The onus has fallen on the government to step in with solutions, because, as the argument goes, the financial services sector resolutely refused to behave responsibly of its own accord. Indeed, in the run up to the crisis, financial corporations were playing regulatory arbitrage and seeking to ratchet the civil foundation back down through deregulation.

This is not the first time that the innovative capacity of business has outstripped its capacity to self-regulate. Our ability to devise new algorithms and exploit weaknesses in the regulatory framework has created crises before. In the early 1990's, **Long Term Capital Management** generated 40 per cent returns to its investors by taking enormously-leveraged positions and using financial models to detect and exploit tiny arbitrage opportunities. In the 1980's, American savings and loans institutions took greater investment risks to meet the challenge of high inflation. They exploited thrift industry deregulation to lend to less secure businesses and to maintain much lower levels of reserves. Of course, both LTCM and the S&Ls eventually collapsed dramatically, driving enormous financial instability.

In all of these cases, including the current one, firms arbitraged regulatory gaps and used innovative instruments to generate private wealth without regard for public welfare. They eroded the civil foundation by forcing the diversion of public funds to offset private downside risk, and worked diligently to minimize regulation and oversight. All went swimmingly until the dynamic systems that underlie the global economy shifted, making the new instruments cataclysmically unreliable. The end result in each case was a widespread public call for increased government regulation (and a not-insignificant decline in the reputation of bankers).

It is a predictable pattern. Blinded by the incentives of Shareholder Value Theory, the system came to rely on past data to predict the future and to ignore its responsibilities to contribute anything other than ever-higher profits. As a result, the government acted to increase regulation and to legislate responsible behaviour.

The problem with this pattern is twofold. First, the pendulum may swing too far: regulators may act with a machete rather than a scalpel and all of us – society and shareholders – may emerge a little poorer. Second, and even more likely, regulators may attempt to control behaviour that has already been completely discredited and abandoned by the industry, failing to anticipate the next arbitrage opportunity or financial derivative. This would leave citizens and businesses as exposed to financial turmoil and risk as they were before.

Moving Forward

Clearly there are exceptions, but in general we have seen a failure of business to show leadership. Instead of striding boldly on their own into the strategic frontier or collectively into the structural frontier to affect positive change, firms have failed to act or have acted to chip away at the civil foundation. This dynamic – and the crisis it precipitated – has encouraged, if not forced, government into action to protect the civil foundation.

Not surprisingly, government has turned to its most powerful tool – legislative action – to buttress the compliance quadrant. This is a legitimate reaction: no government should let corporations profit by diminishing the civil foundation, and legislation can help prevent this. But in this environment, there is a real danger that the government will actually over-expand the compliance quadrant. It is difficult for governments to calibrate their actions and create solutions that are measured and flexible; an overly-aggressive government can inadvertently drive out corporate action in the frontier, to the detriment of society.

While actions that expand the civil foundation are generally positive, a more productive way for the civil foundation to expand is organically – for corporations to venture into the strategic frontier, creating winning ideas that are emulated and copied until they become norms, and for corporations to take collective action in the structural frontier, solving complex problems with cooperation and support of governments.

Given that governments have begun to expand the compliance quadrant, and that actions in one quadrant of the Virtue Matrix affect the others, how should companies think about their own CSR initiatives? Are there still opportunities in the frontier?

The short answer is yes, but there will be challenges. In addition to dealing with expanded compliance, the firm seeking to venture into the frontier faces a new wrinkle: increasingly, corporate initiatives in the strategic frontier are being seen as 'greenwashing'. No wonder, when so many firms have cynically and disingenuously promoted false or misleading green claims: **Shell** recently claimed in an advertisement that their Alberta Oil Sands project was "not only profitable but sustainable." Challenged by the **World Wildlife Fund**, Shell had to admit that its definition of 'sustainable' included economic and social considerations, which led the **Advertising Standards Agency** to rule that Shell had intentionally misled the public with their claim.

This is but one example. A recent study, reported in the *Financial Times*, indicated that almost two-thirds of consumers believe that companies' green communications are merely marketing tools that lack authenticity. All of this makes activity in the strategic frontier more challenging. While it is unwise to give up on action in the strategic frontier, it is unclear to what extent such actions will motivate favourable consumer behaviour in the current climate. And without favourable consumer reaction, strategic-frontier initiatives tend to fail.

It is arguable that in this environment, the most productive approach to corporate citizenship – over and above fully supporting the civil foundation – is to be proactive and creative in the structural frontier. If industries don't get together to promote constructive progress in the structural frontier – by working to produce outcomes that citizens want but which can't be economically produced by the actions of a single firm – governments will take action (as they have in the financial services and automotive industries), and those actions may not be optimal.

There is encouraging precedent for proactive action in the structural frontier. In 1999, in anticipation of the implementation

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of the *Kyoto Accord*, three cement companies began to discuss the painful issues they all faced. They knew that the big global cement producers were disproportionately huge producers of CO_2 and they decided to deal with their challenges as a collective. By 2001, they had formed the **Cement Sustainability Initiative**, an organization of 18 companies under the umbrella of the **World Business Council on Sustainable Development**. These firms recognized that by working together, they could reduce the risk of enacting better sustainability practices to their shareholders and customers. Together, they set out an agenda for action in five areas ranging from CO_2 reduction to local impacts on communities. While the Initiative was triggered by the imminent threats and opportunities of Kyoto, it has also provided an ongoing mechanism to improve the practices of cement companies everywhere. The industry's footprint is enormous: these firms could see that they were at risk of attracting conflicting, protectionist, ill-conceived or capricious regulatory action. By banding together, they have improved their technology, reduced costs and risks and made enormous reputational gains.

There are other encouraging signs. American health insurers, recognizing the threat of a public plan to their domination of a lucrative industry, have chosen to work together with the **Obama Administration** to identify $2 trillion in savings over the next 10 years. At the end of the day, they may deepen the civil foundation by providing health coverage to more unemployed, sick and low-income Americans; and they will have done so by focusing on collective action in the structural frontier.

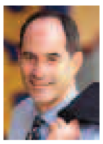
While there is still a role for initiatives in the strategic frontier, right now such initiatives might need to take a lower priority on the corporate agenda. Instead, corporations need to be absolutely certain that they are in full compliance with laws and regulations – and be prepared to demonstrate proactively that they are. They should be on their best behaviour with respect to the norms of their industry and jurisdiction, and they should act boldly on the biggest structural frontier issues in their industry and/or region. The last imperative won't be easy, as the structural frontier demands specific skills: foresight, clarity and collaboration are critical. As in the Cement Sustainability Initiative, firms will need to identify and work with even the most unlikely allies: their own competitors and regulators.

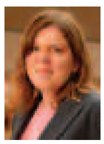
In closing

The goals of CSR have long been poorly defined and unclear, and as a result, companies have been uncertain of the rules or the benefits of doing what is 'right'. As regulations become tighter, money scarcer and solutions more difficult, the capacity of firms to innovate in this arena will become increasingly valuable. Society needs firms to use their most business-like skills – innovation and discernment – along with new tools such as the Virtue Matrix to solve our most challenging problems.

The Virtue Matrix is a tool for helping a company assess and build its own CSR strategy. Which of its activities conform to the minimal-acceptable guidelines of the civil foundation? Where are opportunities for strategic action that exceed the requirements of the foundation and advance the corporation relative to its peers? Where are structural barriers to change, and how can they be overcome? By explicitly addressing such questions, a firm can develop a robust and sustainable CSR strategy.

Here's what companies with great leadership will do: fully comply with the laws of their industry and jurisdiction and be able to demonstrate that they know they are in compliance; meet the highest level of current non-regulated norms; have projects underway in the strategic frontier; and be active participants in structural frontier projects as well. In this way, a company will protect the best of what currently is – the civil foundation – and contribute to the expansion of what *could be*, through activities on the frontier. **R**





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