protiviti®
Risk & Business Consulting.
Internal Audit.

FS Insights

Financial Services Industry Newsletter • Volume 4, Issue 1

Without Reason, Culture Fails

Recent lapses of standards and values have resulted in regulatory inquiries, enforcement actions, financial penalties, resignations and reputation blows for some of the world's largest financial institutions. And while the financial services industry should take no comfort from this, it is by no means the only industry that has failed to live up to the expectations of its constituents. To be fair, the current headlines are just the most recent examples of corporate breakdowns, as we are reminded by this statement from the introduction to a special report in the June 2002 issue of FORTUNE, aptly titled, "Crisis of Confidence."[1]

> "Nearly every known check on corporate behavior – moral, regulatory, you name it – seems to have fallen by the wayside."

What is it in the culture of some organizations that allows these lapses to happen?

The ancient Greek philosopher Aristotle taught us that "all human actions have one or more of these seven causes: chance, nature, compulsion, habit, reason, passion and desire." What's important to note is that only one of these seven causes – reason – relates to logical decision-making.

An organization may define its corporate culture as "the way things get done around here."[2] Culture drives the behavior and actions of an organization's workforce which, in turn, determines the degree of adherence to policies, procedures, regulations and values.

The ancient Greek philosopher Aristotle taught us that "all human actions have one or more of these seven causes: chance, nature, compulsion, habit, reason, passion and desire." What's important to note is that only one of these seven causes – reason – relates to logical decision-making. Having rulebooks, such as codes of conduct and other written policies and procedures, is important, but it is not enough. Too often, organizations fail to recognize that effective corporate governance and compliance depends on managing behavioral risk – the risk that one or more people will make a decision, fail to take action, or engage in an activity that has negative consequences for the organization as a whole.

The organization's goal is to make the case for "reason," to encourage and support people in doing the right thing because it is *the right thing for the organization.*

Most of us were taught "right and wrong" at an early age by our parents and teachers. Some of us were given tips by leaders for whom we have worked. A simple message to a young and up-and-coming professional along the lines of, "I *never* want to see this organization in a negative headline in *The Wall Street Journal*, so if you're struggling with a decision, just remember that," can have a powerful impact.

But behavioral risk isn't just about right and wrong. It can have multiple root causes, both unintentional and intentional. It can stem from circumstances in which employees may have been provided inadequate training, or given unclear instructions or are ineffectively supervised. It can result from the pressure that comes from time deadlines or resource restraints. It may result from poor judgment when well-intentioned individuals misinterpret expectations or requirements. And it can be driven by competitive pressures, hubris or even the challenge of "getting away with it."

The organization's goal is to make the case for "reason," to encourage and support people in doing the right thing because it *is* the right thing for the organization. Encouragement can

Inside This Issue

---

[1] "Crisis of Confidence, Special Report," FORTUNE, June 24, 2002.

[2] *Corporate Cultures: The Rites and Rituals of Corporate Life*, by T.E. Deal and A.A. Kennedy, Harmondsworth, Penguin Books, 1982.

involve carrots and sticks. The reason can be in the form of a benefit: "I know that my company recognizes and rewards me for making decisions that are in the company's best interest." The reason can also be a punishment: "I know that my company will not tolerate my acting in a way that is detrimental to the company's well-being or reputation."

There are any number of lists of the characteristics or attributes of companies that have demonstrated their aptitude at managing behavioral risk and are recognized for their strong corporate cultures. Much also has been written about the intrinsic benefits of a strong corporate culture, such as the views of, respectively, former and current Harvard Business School professors, James Heskett and Earl Sasser, who asserted that "strong, adaptive cultures can foster innovation, productivity, and a sense of ownership among employees and customers. They outlast any charismatic leader," and such a culture "creates a competitive edge that is hard to replicate."[3]

If the leaders of the organization don't recognize their responsibilities to their multiple constituents or that decisions or actions are not just for today, but may have long-term consequences for one or more of these constituencies, there is no reason to expect the rest of the workforce to do so.

The keys to sustaining a strong corporate culture are fairly straightforward:

- **Leaders must set the example.** A leader, as described by John Taft, the CEO of RBC Wealth Management, practices "servant leadership." According to Taft, "It is seeing yourself as holding a type of 'office' in which you are equally accountable to the four primary constituencies of any business – customers, employees, shareholders and the communities in which those customers/employees/shareholders live and work. It is seeing your responsibility as a leader as serving in a balanced way the long-term interests of those constituencies. That is a servant-leadership approach. It doesn't necessarily come naturally but instead is something one has to learn over time."[4] If the leaders of the organization don't recognize their responsibilities to their multiple constituents or that decisions or actions are not just for today, but may have long-term consequences for one or more of these constituencies, there is no reason to expect the rest of the workforce to do so. In this context, leaders include not only board members and members of the C-suite, but also anyone in a management role.
- **There must be an organizational commitment to awareness and training.** Leading organizations are clear not only about the values they believe in, but also about what their expectations are for individual employees. These expectations are set forth in job descriptions and written policies and procedures, and are reinforced through training. If you tell people what is expected of them, then you make it easier for them to understand what they need to do to make the right decision. If leaders "walk their talk" by setting the appropriate example, employees will make the right decision by emulating their example.
- **There must be organizational transparency and openness.** Communication flows within the organization need to be designed to ensure that information goes to the right people in time for them to correct course if a problem is developing. Individuals throughout the organization need to feel comfortable in seeking guidance when they are uncertain how to proceed and in surfacing potential issues and problems. Thomas Donaldson, a Wharton professor of legal studies and business ethics, calls this a "culture of candor."[5]
- **Accountability must be clearly and consistently established and reinforced.** Organizations with strong corporate governance understand that actions speak louder than words. They address consistently and evenly, regardless of level or whether the transgressor is a major revenue producer, instances where individuals operate outside of the organization's rules or values. Just as importantly, however, they also recognize individuals who model the organization's values. Ask employees in these organizations to describe the culture of their companies, and you will often hear the word "fair."[6]

Organizations with strong corporate governance understand that actions speak louder than words. They address consistently and evenly, regardless of level or whether the transgressor is a major revenue producer, instances where individuals operate outside of the organization's rules or values.

It's not that easy, of course. The average person makes hundreds, if not thousands, of choices per day, some trivial and some significant. And if Aristotle is to be believed, reason must compete with emotion and habit as the basis for those choices. That said, the organization that fails to abide by the principles set forth in the four key points we introduced above is clearly at a disadvantage. It's probably the right time for many companies, from the financial services and other industries, to take a hard look at their cultures.

[3] "10 Reasons to Design a Better Corporate Culture," Q&A with James Heskett and W. Earl Sasser, Harvard Business School Working Knowledge, published December 22, 2008.

[4] "John Taft on the importance of culture and servant leadership," by Sean McMahon, SmartBlog on Leadership, July 25, 2012.

[5] "What's in a Title? Overcoming a 'Crisis' of CEO Credibility," Knowledge@Wharton, published August 1, 2012.

[6] "10 Reasons to Design a Better Corporate Culture," Q&A with James Heskett and W. Earl Sasser, Harvard Business School Working Knowledge, published December 22, 2008.

Deriving Value from Mandated Stress Testing

Faced with regular economic changes and shareholder pressure, financial intuitions are seeking ways to provide their organizations and shareholders with value. Stress testing may be an area that both fulfills regulatory requirements and adds value. Per recent regulatory guidance, institutions with more than $10 billion in total consolidated assets will be required to perform regulatory stress tests. These institutions are presented with an opportunity to either consider stress testing as a "check the box" regulatory exercise or to go above and beyond regulatory requirements and integrate stress testing into their strategic management process.

Stress testing may be an area that both fulfills regulatory requirements and adds value.

To derive additional value, institutions need to create an effective stress testing framework and integrate the framework into their strategic planning processes. This process goes beyond what the regulators are asking institutions to do. It requires merging stress testing into multiple bank processes, including risk appetite. The consistent flow of information from the stress testing assumptions and results should provide enhanced decision-making capabilities to senior management and the lines of business (LOB). This would link the stress testing information into the strategic planning process and assist senior management and LOB leaders in exploring business vulnerabilities and determining strategies to optimize their return on capital. This approach is broader than just mandated stress testing and requires risk and finance integration to deliver real strategic value.

Regulatory Environment

Recent regulatory stress testing guidance is anchored by Section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). It requires certain financial institutions, including national banks and federal savings associations, to conduct annual stress tests and requires the primary financial regulatory agency of those financial companies to issue regulations outlining stress test requirements. Additionally, covered institutions must provide this stress testing information to their primary regulators and the Federal Reserve System, as required.

In January 2012, the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) published a Notice of Proposed Rulemaking (NPR),[1] which proposed the annual stress testing requirement under Section 165-(i)(2) of DFA. On May 14, 2012, the regulators (OCC, Federal Reserve Board and FDIC) issued Inter-Agency "Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets" (SR 12-7).[2] Subsequently, on August 16, 2012, the Office of the OCC released a proposal titled "Company-Run Annual Stress Test Reporting Template and Documentation for Covered Institutions with Consolidated Assets of $50 Billion or More."[3] These proposals build on DFA requirements and describe and provide sample templates for reporting; in addition, they are beginning to pave the path for stress testing at smaller institutions – something the largest banks have been working on for several years. The proposals allow institutions the ability to review the proposals, and comment and assess their stress testing programs in relation to the proposed requirements.

The consistent flow of information from the stress testing assumptions and results should provide enhanced decision-making capabilities to senior management and the lines of business.

Key Considerations for a Stress Testing Framework

When institutions design or evaluate their current stress testing framework, they should consider the following items:

- Perform a critical review of all framework elements
- Develop guidelines for the selection of data inputs
- Evaluate source system data flows
- Ensure adequate senior management and board support
- Determine training and business communication and integration requirements

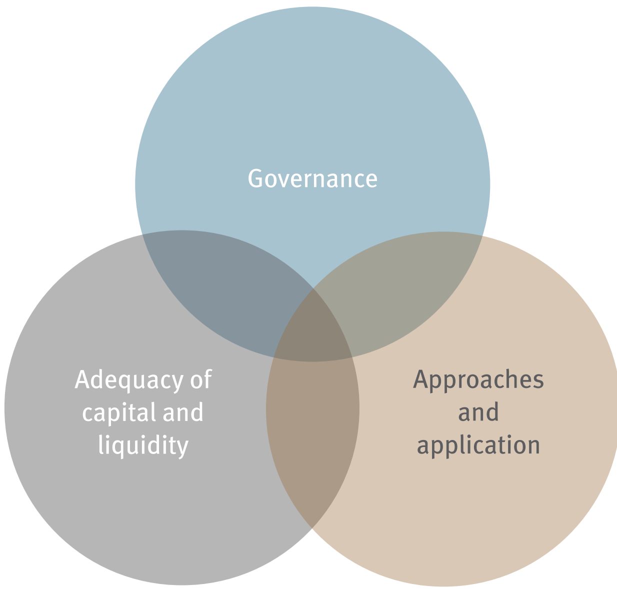
[1] Please refer to our model risk web page at **www.protiviti.com/modelrisk** for additional information on stress testing NPRs and model risk. For regulatory updates, see our regulatory reform web page at **www.protiviti.com/regulatoryreform**

[2] "SR 12-7: Supervisory Guidance on Stress Testing for Banking Organizations with More Than $10 Billion in Total Consolidated Assets," Board of Governors of the Federal Reserve System, May 14, 2012: **http://www.federalreserve.gov/bankinforeg/srletters/sr1207.htm**.

[3] A national bank or federal savings association is a "covered institution" and therefore subject to the stress test requirements if its total consolidated assets are more than $10 billion. Some requirements and/or proposals are directed at institutions with $50 billion or more in assets.

Effective Stress Testing Framework

The regulatory requirements of the stress testing framework are foundationally rooted in the SR 12-7 guidance, and institutions build upon these to create an effective framework. The framework should be broad enough to capture the material risks of the firm and sufficiently flexible to allow for incorporating changes in the institution's risk appetite.



- An effective stress testing framework should have the following components:
  - Capture material activities, exposures and risks, both on- and off-balance sheet
  - Employ multiple, conceptually sound stress testing activities and approaches
  - Be forward-looking and flexible
  - Generate results that are clear and actionable, and inform decision-making
  - Assess adequacy of capital and liquidity currently and prospectively
- For approaches and applications: Institutions should consider the following methods:
  - Scenario analysis
  - Sensitivity analysis
  - Enterprisewide stress testing
  - Reverse stress testing
- For governance:
  - Critical review of framework elements including assumptions, uncertainties and limitations
  - Framework integrated into business lines enterprisewide, as well as senior management and board decision-making
  - Framework commensurate with the complexity of the bank and applicable to the appropriate levels within the bank

The framework should be broad enough to capture the material risks of the firm and sufficiently flexible to allow for incorporating changes in the institution's risk appetite.

Progress to Date

In our experience, while complying with SR 12-7, institutions have found the following areas the easiest to work with:

- Developing policies and procedures around the stress testing framework, its elements, approaches and governance
- Critical review of framework elements, available data and limitations
- Capturing major risks and large exposures
- Determining types of approaches useful and commensurate with risks at the institution
- Producing current assessments of capital adequacy and liquidity
- Establishing holistic governance and information reporting lines

Where Institutions Are Finding Challenges

While complying with SR 12-7, institutions have found the following areas tougher to decipher and implement within their institutions:

- Determining consistency and flexibility with data available for use in stress testing
- Capturing both on- and off-balance sheet exposures
- Developing various scenarios and their underlying assumptions based on data and framework limitations
- Translating a scenario into balance sheet impact, changes in risk measures, potential losses or other measures of adverse financial impact
- Stress testing several types of risks or business lines simultaneously
- Producing forward-looking assessments of capital adequacy and liquidity
- Employing multiple uses of stress testing within various processes of the institution
- Integrating stress testing into multiple levels of decision-making
- Developing tailored reporting for relevant audiences

Deriving Value from the Stress Testing Framework

If institutions utilize their stress testing frameworks appropriately, they can derive the following benefits:

- Operate with a forward-looking risk assessment, rather than a rear-view perspective
- Have robust inputs to the capital and liquidity plan
- Test and overcome model and data limitations
- Identify possibly unforeseen vulnerabilities
- Understand major risk-drivers, their interdependencies and their financial impacts
- Inform the setting of risk tolerances and risk appetite
- Facilitate the development of risk mitigation and/or contingency plans
- Satisfy various regulatory requirements for stress testing
- Provide senior management and the lines of business with information to support and enhance business decisions and risk management practices
- Improve an institution's analytical skills and capabilities

Summary

Institutions have the ability to gain meaningful insight from their stress testing programs and provide value to their organizations if they have a well-designed, implemented and functioning framework. The achievement of value beyond a regulatory exercise requires proper resource allocation, consistent integration, and refinement of a holistic stress testing framework and senior management support.

For More Information ...

Protiviti (**www.protiviti.com**) is a global consulting firm that helps companies solve problems in finance, technology, operations, governance, risk and internal audit.

Protiviti's dedicated Financial Services practice includes professionals with deep industry experience in banking, insurance, brokerage and investment companies. These financial services professionals can work with you to find approaches to help you improve and establish strategies for your business as changes in the industry and regulatory environment impact your organization.

For additional information about the issues reviewed in *FS Insights* or about Protiviti's services, please contact:

Carol M. Beaumier
Managing Director
+1.212.603.8337
carol.beaumier@protiviti.com

Cory Gunderson
Managing Director
+1.212.708.6313
cory.gunderson@protiviti.com

Andrew Clinton
Managing Director
+44.20.7024.7570
andrew.clinton@protiviti.co.uk

Giacomo Galli
Managing Director
+39.02.6550.6303
giacomo.galli@protiviti.it

protiviti®
Risk & Business Consulting.
Internal Audit.

Powerful Insights. Proven Delivery.®