

ESTABLISHING CORPORATE SOCIAL RESPONSABILITY BASED ON INTEGRITY

Observations on financial institutions, human behaviour and compliance

New regulations only strain already overtaxed compliance functions, without preventing systemic crises and loss of reputation.

Internal and external supervision must be more attentive to the human behaviour factor (human risk management); it must be recognized that computerized modelling always tends towards activities at the edges of legislation and stability.

Expertise and professionalism are necessary requirements for integrity, morality and transparency, but these must be rooted in the business culture through observance of the spirit of the law in order to incorporate honest business behaviour.

Organizations which are marked by integrity can count on “market dividends”. They also deserve “supervisory dividends”.

INTRODUCTION

In the aftermath of financial crises (Worldcom, Enron, Parmalat), financial institutions are confronted with calls for stricter observance of tightened regulations concerning governance and financial reporting, such as Sarbanes Oxley and its European equivalents. Both supervisors and (activist) shareholders push for stricter compliance. The current credit/trust crisis has generated the same reaction: supervisors prepare tighter and new rules in regard to, among other things, take-overs, the functioning of financial markets and earnings systems. In addition to the already existing and detailed legislation (for example MiFID and the Payment Services Directive), new regulation will burden the compliance functions of financial institutions even more. This is not to mention the ‘common’ regulations, compliance with which is overseen by the supervisors. These developments take place in a period when the role of the CEO has become more powerful and changes in the composition of governing boards have become more frequent. In this environment, stricter compliance has been incorporated into the corporate culture without the basic values, which respond to the spirit of the law, being firmly rooted in the undertaking. We have in mind broadly-shared basic assumptions that the pursuit of Profit embraces People, Planet and Principles, the core of Corporate Social Responsibility (CSR). Without this change taking place, stricter compliance will not lead to greater observance. Then, the danger of loss of reputation of financial institutions and their supervisors looms, while long-term continuity, solidity and stability remain distant and obscure.

***To a greater extent, Profit should be pursued in relation to People, Planet and Principles,
the core of Corporate Social Responsibility***

Our case

In order to guarantee structurally sound business management, aimed at long-term continuity, solidity and stability, we argue that the compliance/corporate governance question be dealt with from a 360-degree perspective rather than by instant and sole reliance on more regulation. After all, the trust crisis has also been caused by the long-term presence of faulty impulses in financial markets as well as somewhat naïve control systems. We do not only speak of the wrong impulses

within financial markets coupled with a somewhat ignorant supervisory system. Nor do we only speak about wrong incentives within financial institutions in the form of much-criticized excessive earnings. We also speak of a situation created in financial markets which has greatly contributed to the erosion of risk-awareness and has encouraged acceptance of irresponsible risks. By this, we mean the excessive increases of international liquidity by central banks in a period of, first, falling and, then, long-term low and continuing inflation. Official and market tariffs reached such low levels that financial institutions took more risks in their pursuit of high returns. A long period of low insolvencies caused razor-thin risk surcharges no longer to reflect real risk. Both monetary and other supervisors lack adequate overview because of compartmentalization between countries, within countries, and between markets. Supervision at the national level has not proven adequate for a satisfactory oversight of tightly interwoven international markets and institutions. We are now faced with the full force of the serious consequences of these developments. Against this background we do not believe that more regulation, by itself, will lead to the intended restoration of trust in financial markets and institutions. This conviction has been reinforced now that supervisors and national governments have made clear which priorities are given in deciding which financial institution will be allowed to fail and which will not (by means of bail-out and nationalization, full guarantees of deposits and protectionism). This has given rise to a lot of “moral hazard”. Financial institutions that know they are considered important for the stability of the financial system (and for important segments of the voting public) are allowed to continue taking risks that are denied to institutions that do not belong to this category. Traditional rating agencies cannot be relied upon to provide a solution to the issue of moral hazard as they structurally allocate a higher level of credit-worthiness to the first-mentioned class of financial institutions and, thus, are partially to blame for perverse reactions by the market players.

We argue that the internal and external supervision of financial institutions should give much more attention to human behaviour as a factor of importance. The crucial importance of these “soft” aspects (“intangible assets/liabilities”) must be recognized, especially within risk-departments. In order to judge the continuity, solidity and stability of individual institutions we apply six basic requirements, the so-called 6 Cs (core principles). These principles must also contribute to the 4 Ps of Profit, People, Planet and Principles, leading to an intrinsic ‘Triple A rating’, instead of the current ‘rating triple A’.

The 6 Cs are:

- i) Corporate Governance
- ii) Compliance
- iii) Crucial Human Risk Management
- iv) Culture (composed of Decency, Integrity and Transparency)
- v) Customers and Commerce
- vi) Control

This article discusses an integral approach to the 6 Cs, especially in relation to supervised financial institutions but our approach has much broader application.

Analysis

We see the following state of affairs:

- i) In the last decade, many issues have become fixed in laws and regulations and a marked tendency towards rule-based supervision can be discerned. Even in situations where the approach is principle-based, the implementation of the principles is often based on rules. This results not

only from the rule makers filling in the principles by explanations and examples but also from financial institutions themselves implementing principles in internal rules in order to avoid supervisory sanctions. As we see it, compliance has become too controlling and custodial.

ii) Simultaneously, earnings systems are based too much on faulty or inadequate criteria, leading to variable earnings. Bonuses and careers too often depend on meeting commercial targets and instant obedience to management. This has put pressure on ethical behaviour among human beings.

iii) Credit ratings and investment analyses take little or no account of the intangibles (soft aspects) of organizations. In the end, subjective judgements and commercial considerations more often than not are the deciding factors in the rating given.

iv) Hierarchical models have won terrain (at least until recently) as opposed to collegiate models whereas, within the collegiate model, the chairman has become a CEO. Such governing models call for extra attention to checks and balances in order to guarantee an open internal business culture and good compliance.

v) Too little attention is paid to whether market conditions influence the observance of proper behaviour.

And these, unfortunately, are the current consequences:

i) Compliance is not part of the internal corporate culture, but is an (often automated) control mechanism keeping watch over observance with all the rules. The letter, not the spirit, of the law prevails.

ii) The staff is incentivised to concentrate on short-term maximal financial returns; other factors are only side constraints, if they are considered at all.

iii) Many companies promote uniform and obedient adherence to rules. In larger financial institutions, individual responsibility and taking initiatives are not rewarded. The opposite is more often the case. As soon as individual responsibility compromises commercial interests, corporate tolerance evaporates to zero. Doing business in line with the spirit of the law is risking your neck.

iv) Shrinking public trust in the stability and continuity of financial institutions. Just as 'Safety' is key for the airline industry and 'Location' for real estate, 'Trust,' 'Trust' and 'Trust', again, is the essential requirement for financial institutions to ensure successful running of their business and their long term continuity. We are talking here of an 'intrinsic triple-A' and not a 'triple A' attributed by credit rating agencies. Some examples of results of an improper corporate culture and earnings system are: a) product development departments where the earnings potential of the institution or of the department itself is more important than the interests of the customer; b) sales departments that, rather than risk their sales bonus, sell products without a full understanding of the risks involved, or do not inform unsuspecting customers of the risks; c) risk management that too often is aimed at systems and procedures.

The above defined results lead us to the following conclusions:

In addition to hard-numbers criteria, 'soft' criteria are important for judging the quality of a business. Supervisors and the full board (in a one tier board structure) or the supervisory board (in a two-tier board) must test these and management must strive for this quality. These criteria must weigh heavily, not only in the context of internal appraisals for the purpose of management but also externally, for the purpose of the stakeholders. Therefore, adjustments must be made to corporate rating systems. Furthermore, a different, broader, vision of compliance and its implementation is of great importance. We will discuss this below.

Integral vision of Compliance/Corporate governance

Authors use many different definitions of 'compliance'. The most common are variants of "observance of laws and legislation"¹. The Basel Committee², however, has a more comprehensive definition, "the risk of legal or regulatory sanctions, material financial losses, or loss to reputation a bank may suffer as a result of its failure to comply with laws, rules, related self regulatory organization standards, and codes of conduct applicable to its banking activities." The most important supplement to the 'simple' definition would be naming the risks incurred in not observing laws and regulations. Interestingly, the Basel document presents very important elements of compliance and the compliance function that elsewhere are not, or barely, considered, such as the independence of the compliance officer and the roles of management and directors. As is more often the case in areas of financial supervision, these points are unfortunately dealt with mainly in a technical manner. We consider that more emphasis must be placed upon human behaviour and corporate culture: what must the CEO do if the compliance officer is of the opinion that a deal cannot go through? Does the Supervisory Board verify whether senior management is of exemplary behaviour? Only when questions such as these are addressed can real change be realized in matters of compliance and corporate culture.

The spirit of the law and its observance must be embedded as an essential element of corporate behaviour.

The corporate culture

Crucial, among other things, are the content of the business culture, the business principles, the codes of behaviour, the exemplary behaviour of senior management and the extent to which this kind of behaviour is incorporated within the enterprise and practiced by individual employees. The spirit of the law and its observance must be embedded in the corporate culture. Otherwise, the compliance culture is like an oil spill drifting on water: it is clearly visible, but it doesn't mix.

Incentives

Many bonus systems are directly linked to short-term commercial returns. Often, they are linked only to the results of the unit involved. When capital requirements and other supervisory rules are inadequate, this can lead to irresponsible acceptance of risk. Earnings systems based on larger entities work better because there are more checks and balances involved. More importantly, earnings systems must stimulate ethical conduct of business. 'Soft' and long-term criteria must be incorporated into earnings systems, with a subservient role for variable earnings.

Integrity, morality and transparency

Expertise and professionalism are necessary requirements for integrity, morality and transparency in the business culture, but ethical behaviour must root these three elements in the corporate culture. Likewise, ethical behaviour must find its place in the appraisals and earnings systems.

¹ In this contribution we limit ourselves to the compliance in regard to the prudential legislation, even though we are aware of the fact that other financial rules (e.g. those concerning economical sanctions or anti-terrorist measurements) and non-financial rules (e.g. those concerning the environment or competition) deserve as much attention when considering observance of the law.

² Basel Committee on Banking Supervision, Compliance and the compliance function in banks, see: <http://www.bis.org/publ/bcbs113.pdf?noframes=1>.

Law and regulations

Corporate behaviour must strive to promote the observance of the spirit of the laws and regulations. Organizations that have incorporated this element into their culture must get a reward in a lowering of their 'supervisory burden'. This may take the form of lesser sanctions when incidents occur, or an easing of regulatory pressure. A financial institution following such an approach should be able to count on the goodwill of the supervisor. There must be something similar to what the British Financial Services Authority calls a 'regulatory dividend'³. But how must a supervisor decide whether an institution is eligible for a 'regulatory dividend'? That can occur in an objective, verifiable manner. One possibility would be the incorporation of a separate compliance/governance review function in the credit-rating system. The supervisor could undertake the review himself but another option would be for specialized, independent raters (not traditional rating agencies) to undertake this review and provide an opinion. It is advisable that the supervisor test the method to be used for reliance thereon in its own supervisory judgment on the institution thus rated.

Analysis and rating methodology

In addition to the analysis of financial results, other elements are important in rating long-term continuity, solidity and stability, as already mentioned.

Such other elements to consider in rating include:

- i) the external economic climate and regulatory environment;
- ii) the compliance culture in relevant markets
- iii) the company's internal compliance culture;
- iv) the implementation of compliance in risk-sensitive areas and departments;
- v) personnel policy in the risk departments: diversity (gender, age, competence, cultural background, experience, etc.), earnings systems and appraisals criteria on which earnings are based.

The rating procedure starts with an analysis of public information regarding the institution, provided by analysts, other sources of public opinion on the firm, special interest groups (e.g., consumers and policy holders), and information which the organization is required to yield upon request. This could be in the form of an 'information questionnaire', because these data could be used for a 'peer analysis'. Afterwards, a list of questions would be compiled for the purpose of holding interviews with all key players in respect of compliance and governance within the organization. These should include management, the board of directors (or supervisory board) and external accountants. Additionally, lower to middle management levels should be questioned. The analysis would be enhanced by supplementary (anonymous) inquiries among the work force of risk departments, and among major investors, suppliers, and customers. From the information all these relevant sources would supply, opinions could be formulated, recommendations made, and 'milestones' put in place.

***Our preference is for specialized external, independent organizations
to rate the quality of the corporate system.***

³ Well controlled and managed firms that engage positively and openly with us and the outcomes that we are aiming to achieve should expect to experience real benefits in the form of a 'regulatory dividend'. FSA < *Principle based regulation – Focusing on the outcomes that matter, Ten point summary*, 25 April 2007, <http://www.fsa.gov.uk/pubs/other/principles.pdf>.

Further insights for the organization into the rating can be realised by separate examination and scoring of the different aspects. These individual ratings, each with its own weighting, would ultimately determine how the institution is rated on a limited number of main aspects, and the resulting overall final rating. Such an approach promotes management of ‘tangible and intangible’ assets and liabilities within organizations. This analysis could be conducted within the organization itself, but this would require that it is undertaken by independent staff members who would make impartial judgements. If this crucial fringe condition is not met, such an analysis would have little value. Our preference is for calling in the services of external specialized, independent organizations. After discussion of the results and implementation of recommendations in a pilot-atmosphere this new compliance/governance approach could be made public. That would be the proper time for the external supervisors to extend a ‘supervisory dividend’ to the organizations concerned. Monitoring the recommendations and milestones could ensure that compliance with check list and control techniques would be replaced by a corporate culture in which socially responsible enterprise is of a primary goal of the undertaking.

Our Theses

The foregoing leads us to the following theses:

Thesis 1: Optimal long-term business results and a related rating of the institution and its debtor status are only achievable if socially responsible entrepreneurship is visibly rooted in the corporate culture.

Thesis 2: The company’s culture must encourage and allow employees to take an ethical and critical stand concerning the functioning of the company they work for. Earnings systems (monetary rewards and promotion) should stimulate such a positive but critical attitude.

Thesis 3: Detailed laws and regulation by themselves are not enough to prevent serious, systems-threatening crises.

Thesis 4: Rule-based laws and regulation are important in guaranteeing a level playing field and thus crucial alongside principle-based regulation which should guide the behaviour of market participants.

Thesis 5: Only when regulation leads to more principle-based corporate compliance and governance, can the administrative burden of rule-based regulation be eased.

There are many explanations for the fact that regulation has not prevented the occurrence of crises: we shall name the most important. Firstly, supranational and national regulation is not the same everywhere and is not interpreted in the same way (level playing field: compare the U.S., Europe, and within Europe, the U.K). Secondly, not all financial institutions that function in financial markets fall under supervision or under supervision of the same intrusiveness. (White spots: compare commercial banks, investment banks, insurers and investment funds.) Thirdly, regulation is technical in nature; the system pays little attention to the intangibles of organizations (is human factor ignorant) which, among other things, leads to faulty impulses for employees and management. And fourthly, there is a skills deficit among directors, compliance teams, and their internal and external (official) supervisors in overseeing, among other things, the financial and monetary consequences of financial innovations. In short, Basel 2, SOX, new legislation, and supervisors did not prevent the credit crisis, nor did they foresee it.

Thesis 6: Numerical approximations, strict regulation, computerized control mechanisms and earnings systems do not by definition lead to the desired objectives these systems aim for.

One may not assume that human behaviour provides sufficient checks and balances against irresponsible and risky actions. Abstraction is usually also made of the economic environment in which the institution and its employees must perform. The compliance system described can

function only in a limited set of defined situations. Unintentionally, computer models meant to guard the rules lead companies to seek the edges of these rules.

Thesis 7: Optimal long-term results can only come within reach when, besides strict rules, also and especially ‘soft’ aspects and the spirit of the law and codes of behaviour are embedded in the corporate culture.

Insights into the behavioural sciences must be used to ensure not only that formal rules are strictly observed, but also that integrity, morality, transparency and the spirit of the law are encouraged in corporate behaviour. Top management must lead the way in this. The supervisory board must ensure that this element of management plays an adequate role.

Thesis 8: Legislators and supervisors must forsake their ‘standard reaction’ concerning the introduction of new (extra) legislation.

While new legislation may address a topical problem, it also leads to a further tightening of the “profusion of legislation”, causing legislation to prevail over principles. Moreover, there is little or no guarantee that the fundamental cause of that problem will be eliminated. Yet, clear, uniform and detailed legislation remains necessary alongside principle-based regulation. Examples are frequently occurring cases like required identification (Know Your Customer rules and Customer Due Diligence). In a lot of situations, open rules are more effective. A good example is the modification in the Dutch legislation of a great many objective criteria to one single ‘open’ criterion when reporting ‘unusual transactions’.

Conclusion

We plead for a 360-degree, integral approach to compliance and governance in organizations, and use financial institutions as an example. Our convictions have been reinforced by the serious international credit, trust, and integrity crisis. Its causes indicate that compliance is not adequate to prevent calamity if it is conceived to be a technical and check-list problem. Moreover, it appears that by the introduction of quantitative models and techniques, management has not become more ‘under control’ but, rather, more ‘out of control’. Financial supervisors have inadequate overview and control of the situation because of compartmentalization within and between jurisdictions. Governments and tax payers have been taken hostage by the financial crisis and will only regain their freedom by paying ransom money. It is high time that compliance via proper, honest, and transparent behaviour by humans and institutions is rooted in the corporate culture or, put differently, it is high time that serious attention be given to human risk management (HriM). The spirit of the law must be observed and the observance thereof embedded as an element of corporate culture. Knowledge of the behavioural sciences can help root these systems in the business procedures and business culture. Businesses must acknowledge that they stand as much for People, Planet and Principles as for Profit. Stakeholders, analysts, raters and supervisors must stimulate financial institutions to change course by administering the appropriate rewards and sanctions. Such an approach implies a big change in the current way of thinking. But there are many advantages to this change of direction. Such adapted behaviour has to become part of the criteria of socially responsible entrepreneurship. A commercially honest and transparent financial institution must act on the interests of the customer while observing its own business interests. Credit raters (internal and external) must assign a lower risk profile to such an institution. The external supervisors can influence the positive rating of financial markets and customers by awarding a ‘regulatory dividend’, a sort of ‘bonus-malus’ policy, when establishing the level of supervision, and only apply sanctions when the behaviour is more serious than an incident, or when a calamity has occurred. The reward we expect would consist of lower capital costs, ample funding possibilities, more customers and a more forgiving

supervisory regime. This would seem to us to provide a sufficient stimulant to implement the kind of governance we aim at. Only then will we be able to get a perspective on long-term continuity, solidity and stability of individual financial institutions, with the appurtenant measure of integrity, morality and transparency.

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