November 2009

The Seven Elements of an Ethical Culture

Strategy and approach to behaviour and culture at financial institutions 2010-2014

1 INTRODUCTION

Trust is the basis of the financial system and a central theme in all of DNB's activities. The financial world has experienced a crisis of trust over the past two years. Confidence in the financial health of enterprises took a blow, while a series of incidents generated public mistrust in the culture prevailing within institutions. The key concerns are the lack of impartiality and unhealthy risk appetite within the financial sector. The social outcry is coupled with a call on DNB to do more to improve the behaviour and culture at financial institutions.

Supervision seems to have offered too little resistance to a culture in which third parties' interests ranked lower than institutions' own objectives[1]. The shift to principle-based supervision with open standards led to a greater reliance on supervised institutions' own responsibility and intrinsic sense of values. DNB is responsible for guarding these principles and standards, without becoming a moral crusader. One of the ways to fulfil this role is to effectively promote ethical behaviour by institutions and persons through the internal corporate culture. This fits in with DNB's duties as prudential supervisor, which include the monitoring of institutions' business operations. DNB views a values-led corporate culture as an important internal factor.

DNB sees ethical behaviour as a professional, individual responsibility. Individuals should be aware of the rights, interests and wishes of other stakeholders and conscientiously take them into account, have an open and transparent mindset, and be willing to take responsibility and be held accountable for their decisions and actions.

An ethical culture denotes a climate and atmosphere in which a firm, in a broader sense too, behaves or acts in a way it can explain and account for. A culture in which this professional, individual responsibility is stimulated and rewarded, and which not only respects the letter of the law, but also its spirit. The Seven Elements underpinning this culture are: balancing of interests/balanced actions, consistent actions, openness to discussion, leading by example, feasibility, enforcement and transparency.

The issue of behaviour and culture has recently appeared on the agenda of DNB's Governing Board from a range of perspectives. The Supervisory Strategy 2010 – 2014, which names this topic as one of the all-embracing issues for the future of supervision, the requirements on the

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[1] See A.H. Scheltema and M. Scheltema, Financial supervision in administrative and private law, 2009: When private parties can completely aim their creativity on promoting their own interests and as long as they are not corrected by supervisors, they do not have to take any responsibility to not harm the public interest and will always find new ways to prevail their own interests above those for which the supervisor stands. A system of public laws and supervision is an insufficient countervailing power for those very strong incentives of private parties.

expertise of policymakers at financial firms, and the principles for sound compensation policies are of particular note.

This document presents DNB's strategy on the issue of behaviour and culture. It describes the background and reasons why it is important to include ethical behaviour and culture in supervision, sets out the legal framework for doing so, and explains what the current situation is, both within institutions and in the exercise of supervision by DNB. In presenting these elements for an ethical culture and sound conduct, this document describes the supervisory model that DNB wishes to follow in determining its supervisory efforts and, in a general sense, the plan of action for 2010–2014.

2 JUSTIFICATION

Besides business and economic reasons of protecting customer confidence in the financial sector, there are various arguments in favour of paying more attention to behaviour and culture: these are rooted in the public interest and the legal framework.

2.1 The public interest

The public is now calling on DNB to adopt a more active stance in the debate on defining the limits of socially acceptable behaviour. The incidents of the past two years have contributed to the impact of the financial crisis. Various organisations have researched, or are now researching, the causes of the crisis and have proposed policy measures[2]. A common standpoint is that financial institutions have a public function in addition to their existing legal and social responsibility to treat the funds entrusted to them carefully and correctly. With a view to restoring confidence in the financial sector and maintaining backing for the state support it has received, there is a public call on DNB to extend its focus to (also) cover ethical behaviour and culture.

The incidents reflect a trend in the business sector's approach to ethical business conduct over the past few years. Enterprises gave priority to short-term profits and the interests of the shareholders, putting them before the interests of employees and customers, the enterprise's continuity and society. Banks and other financial institutions lost sight of their public function. They are important to society and should thus take care of their tasks in a careful and correct manner. More generally too, financial stability is a global public good. Parties that play a role in safeguarding financial stability should take the various interests into account. Banks did not adequately consider the public costs related to their private actions.

The accumulation of incidents caused public unrest and undermined confidence in the financial sector. The lessons that can be drawn from these incidents could be used for rebuilding and

[2] National: Advisory Commission on the Future of Banks, *Naar herstel van vertrouwen* [Towards restoring confidence], 7 April 2009. This formed the basis for the Banks' Code, 9 November 2009. International: Institute of International Finance, Final Report of the IIF Committee on Market Best Practices: Principles of Conduct and Best Practice Recommendations, July 2008; 'Group of Thirty ' (Chairman Paul Volcker), Financial Reform, A Framework for Financial Stability (Report with 18 recommendations for thoroughly reforming the financial system), January 2009.

restoring confidence in the financial sector. This is also the sentiment that emerges in many articles and interviews with experts that have appeared in the press.

Various publications rank the behaviour at financial institutions among the causes of the financial crisis. In a climate in which short-term returns were rewarded, financial sector staff took unacceptable risks and customers were no longer the key focus. Financial institutions had dealings with counterparties without first conducting proper due diligence. Institutions invested in certain financial products without properly understanding them and without a clear view of all the (legal and financial) consequences[3].

Several experts share the view that, in order to renew confidence in the financial sector, financial institutions should go back to focussing primarily on their customers; should not let their strategy depend on their institutions' share prices, and should make a sound assessment of new risks. Strong emphasis is placed on the public function of banks. Moreover, bank directors should shoulder their social responsibility in the daily performance of their tasks. Another recommendation that is often put forward is that supervisory boards should develop more expertise and take a more critical approach in their internal supervision[4].

The common undertone in the different publications is that banks' should place their search for profit in the larger context of people, planet and principles. The principles should be embedded in the corporate culture and consistently reflected in corporate decisions[5].

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[3] See, for example, *Het Financieel Dagblad* (FD), 22 December 2008, interview with Onno Ruding, *'Kritiek dat banken niks doen met staatshulp is goedkoop*' [Criticism that banks do nothing with state aid is cheap]; *NRC*, 28 December 2008, *De daders zijn opeens slachtoffers geworden* [Culprits have now become victims]; FD, 13 December 2008, interview with Angelien Kemna, *'Ik was gewend om invloed te hebben door mijn positie. Nu moet ik het doen met mijn innerlijke overtuiging*' [My influence used to come from my position. Now it has to come from my inner conviction]; FD, 19 December 2008, *Populariteit van dure hedgefondsen bij pensioenbeleggers is voor even voorbij* [Expensive hedge funds out of favour among pension investors for now]; *Volkskrant*, 3 January 2009, *Bankier zonder goede voornemens* [Banker without New Year's resolutions].

[4] For example FD, 11 December 2008, interview with Jean Frijns, *'Ik heb commissarissen als groep gemist'* [I missed Supervisory Board members as a group]; NRC, 19 December 2008, interview with Alexander Wynaendts *'Te weinig op ons gezonde verstand vertrouwd'* [Not enough trust in our common sense]; FD, 24 December 2008, interview with Wilco Jiskoot, *'Absolute waarheden bestaan niet, er is alleen een dynamische werkelijkheid'* [No such thing as absolute truths, only a dynamic reality]; FD, 20 December 2008, W.H. Buiter, *Test financiële producten vooraf* [Test financial products in advance]; FD, 20 December 2008, J. van Mierlo, *De mens wil niet luisteren, noch in goede noch in slechte tijden* [People don't want to listen, neither in good times nor bad]; FD Magazine, December 2008, interview with Paul Koster; NRC, 3 January 2009, *Deze mannen weten hoe het was om saai en sober te zijn* [These men know what it was like to be dull and frugal]; FD, 3 January 2009, *Gebrek aan vertrouwen* **-** *Toets alle bestuurders op integriteit* [Lack of trust – assess all directors for fitness and propriety]; FD, 9 January 2009, *Niet bang zijn en doorvragen* [Don't be afraid and keep asking]; FD 27 March 2009, column by Jaap Winter and Kees Cools *'Te veel gevraagd*' [Asking too much] in which the authors argue that active supervisory board members are not a panacea for all kinds of problems.

[5] See B&E, October 2008, Hein G.M. Blocks et al, *Inbedding van MVO door verankering van integriteit* [Embedding CSR by integrating integrity]; FD, 10 February 2009, column Rens Rozekrans: 'Niet bezuinigen op compliance [No cost-cutting on Compliance]; FD 12 June 2009, column Jaap Winter and Kees Cools, 'Doen' ['Act'] in which a case is made for steering on behaviour by way of 'rules of life'. An example of maintaining core values is Banco Santander. In a television broadcast on Fortis bank it is suggested that because of its core values, this bank was not hit by the crisis (1 Februari 2009, the Fortis-files, Canvas, Belgium).

2.2 Legal basis

There is a legal basis requiring financial institutions and the supervisor to devote attention to ethical behaviour and culture. This basis arises from the prudential supervisory task, notably the supervision of sound and controlled operations.

In the Netherlands, DNB is responsible for prudential supervision. This supervision is geared to the soundness of financial institutions and contributes to the stability of the financial sector. It aims to promote the security of financial entitlements, stability and integrity of the financial system and the efficiency and reliability of payment systems.

Prudential supervision serves to protect the interests of customers of financial services, bank creditors, policyholders and investors. Customers should be able to assume that the financial institutions concerned will meet their obligations. To ensure that this trust in the financial sector is justified, DNB exercises prudential supervision on financial institutions. The legal basis for the prudential supervision of most types of financial firms is provided by the *Wet financieel toezicht* or *Wft* [Financial Supervision Act], and for the pension funds and occupational pension schemes by the *Pensioenwet* or *Pw* [Pension Act] and the *Wet verplichte beroepspensioenregeling* or *Wvb* [Act on Compulsory Membership of an Occupational Pension Scheme] respectively.

Sound and controlled operations
A financial institution should set up its business operations in a way that guarantees the sound and controlled performance of its activities. Each institution should have a clear picture of how its operational processes are controlled. This means that the risks have been identified and that sufficient control measures have been taken to combat them. Such control measures include the segregation of functions, frameworks and guidelines, and procedures for the administrative organisation. Internal control is the process aimed at obtaining a reasonable degree of security about the realisation of an organisation's objectives.

In addition, institutions must structure their business operations in a way that guarantees their sound performance. Integrity, like reliability, is a prerequisite for a healthy financial system. That is why integrity has a statutory basis in financial legislation. To promote financial sector integrity, it is essential that financial institutions control their integrity risks. Control of these risks is part of an institution’s business operations.

Sections 3:10 and 3:17 *Wft* with regard to sound and controlled operations are the most relevant to this topic (for pension funds and occupational pension schemes, see Section 143 *Pw*, Section 138 *Wvb* and Sections 18, 19 and 20 of the Decree on the financial assessment framework). These sections provide that a financial undertaking must have adequate policies and be set up in such a way as to guarantee the integrity of its business.

In setting up their operations, institutions are hence obliged to do the following:

- Counteract any involvement of the institution or its staff from committing offences or violating the law, which could harm the public’s confidence in the institution or the financial markets;

- Counteract relations with customers which may affect the confidence in the institution or the financial markets; and (particularly relevant in this context)
- Counteract any acts by the institution or its staff from committing other acts which go against what − according to unwritten social rules − is considered socially proper and consequently would seriously harm trust in the institution or the financial markets.

In principle, it is up to the firm itself to develop and implement its policies and administrative organisation, except that the *Besluit prudentiële regels* or *Bpr* [Decree on Prudential Rules] sets minimum standards with respect to management and the policy cycle, conflict of interests, incidents, integrity-sensitive positions and the acceptance of customers (Sections 10 – 14 *Bpr*).

These minimum standards, and particularly the attendant legislative history, bring us to the key concept of a 'values-led corporate culture'. First and foremost, it is important that the financial firm systematically draws up its own analysis of integrity risks. Using this analysis, the financial firm formulates its policies and, if necessary, adjusts them in a way that permanently guarantees the sound performance of business operations. Subsequently, the financial firm must translate its policies into organisational and administrative procedures and measures. As emphasised in the Explanatory Memorandum to the *Wft*, the legislator has stated that this embedding in the business processes contributes to a values-led corporate culture and that the corporate culture is an important internal surrounding factor in embedding soundness of operations. The legislator does not colour or interpret this important surrounding factor.

Within its supervisory task, DNB has various enforcement measures at its disposal to compel ethical behaviour. These relate primarily to the hard controls such as policies, procedures and measures. If undertakings carry out acts which – in brief - conflict with what is deemed sociably proper, DNB can act to enforce compliance with supervisory legislation; in such cases, too, DNB may impose a cease and desist order or an administrative fine. However, with reference to the actual possibility of enforcing the standard, the legislator makes the following note to Section 3:17 Wft:

"It can not always be established whether an action conflicts with what is socially acceptable. Moreover, social standards are constantly subject to change. (...) the scope is thus restricted to indisputable breaches of the social norm that seriously harm trust in the financial firm or in the financial markets ". Such a standard, and the explanatory note to it, considerably restrict the possibility for enforcement. DNB hence argues for a stronger basis in the laws and regulations.

Other (international) reference points
For some time now, leading organisations have also stressed the importance of promoting a values-led corporate culture. The Basel Committee, for example, states[6]:

[6] Basel Committee on Banking Supervision, "Compliance and the compliance function in banks", April 2005. Other relevant documents are the IOSCO report of March 2006 'Compliance function at market intermediaries' which mentions that 'it is equally important, however, that firms develop a business "culture" that values and promotes not only compliance with the "letter of the law," but also a high ethical and investor protection standard.' Of IAIS reference is made to ICP 9 on corporate governance and 'Guidance paper on preventing, detecting and remedying fraud in insurance' of October 2006.

"Compliance starts at the top. It will be most effective in a corporate culture that emphasises standards of honesty and integrity and in which the board of directors and senior management lead by example. It concerns everyone within the bank and should be viewed as an integral part of the bank's business activities.

A bank should hold itself to high standards when carrying on business, and at all times strive to observe the spirit as well as the letter of the law. Failure to consider the impact of its actions on its shareholders, customers, employees and the markets may result in significant adverse publicity and reputational damage, even if no law has been broken."

In 2002, the FSA in the UK also formulated principles for an "ethical framework for financial services". This framework sets out the incentives that may influence behaviour and describes how the financial sector could operate in an ethical way that meets society's current demands and expectations.

A brief tour of foreign supervisors and discussions with members of relevant international fora show that – apart from some aspects of behaviour and culture, such as governance and remuneration policies, the topic is not, or not yet, on the international agenda. The question before us is whether DNB should raise this issue.

The crisis in confidence has once again brought it home that soundness not only rests on a business economics but also on an ethical and moral component. This leads to the conclusion that DNB, as the prudential supervisor, could and should more concretely incorporate the open standard of an ethical corporate culture in the risk-orientation underpinning its supervision, assuming that the legal basis exists.

3 VALUES-LED CORPORATE CULTURE - THE SEVEN ELEMENTS

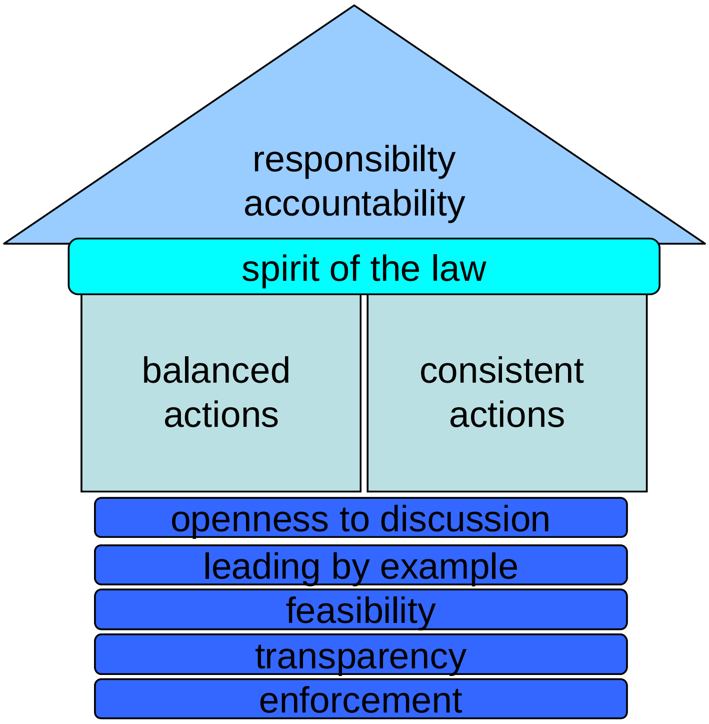
DNB's vision of a 'values-led corporate culture' refers to a climate and atmosphere in which a firm, besides complying with laws and regulations, is also able to explain and justify its actions and behaviour in a broader sense. A culture in which professional, individual responsibility is encouraged and rewarded; a culture in which people act in line with the spirit of the law. In order to embed ethical behaviour in the sense of taking responsibility and accounting for one's actions in the corporate culture, a firm should integrate the following elements[7] in its culture:

- **Balancing of interests/balanced actions:** identifying all relevant interests and demonstrably taking them into account
- **Consistent actions:** acting in line with objectives and choices

[7] See H.A. Annink and R.J. Hoff, *Integriteit en verzekeraars (1): de integere bedrijfsvoering, in TVC* [Integrity and insurers (1): sound business operations, in TVC]; E.D. Karssing, *Moreel beraad: de grote uitdaging voor de komende tien jaar*, *Jaarboek Compliance* 2006 [Moral considerations: the major challenge for the next ten years]; Hein G.M. Blocks et al, *Inbedding van MVO door verankering van integriteit* [Embedding CSR by integrating integrity], B&E, October 2008; F.P. van de Wouw, *Als regels niet voldoen*, [When rules do not suffice], Jaarboek Compliance 2008; M. Kaptein, *De manager als soft control* [The manager as soft control], in congress report on Integrity and the assessment of soft controls, 17 April 2007.

- **Openness to discussion:** encouraging employees to take a positive, critical approach and giving scope for discussing decisions, other views, errors and taboos
- **Leading by example:** good behaviour at the top (personal integrity, including the prevention of an (apparent) conflict of interests)
- **Feasibility:** setting realistic targets and removing adverse incentives and temptations
- **Transparency:** determining and communicating targets and principle choices to all stakeholders
- **Enforcement:** attaching consequences to non-compliance

DNB often uses the image of a house resting on various pillars when describing its supervisory task; the figure below illustrates behaviour and culture in the same way. Balanced and consistent actions are the main pillars supporting ethical behaviour (in other words, taking responsibility and accounting for one's actions; acting in line with the spirit of the law) whereas the other five elements form the foundation to reach this objective.



Financial firms face the challenge of putting these Seven Elements into practice in such a concrete way that ethical behaviour becomes a natural component of the corporate culture. How does the firm interpret these elements and what activities does it undertake to ensure that a positive culture is maintained?

This is a continuous and dynamic process in which every aspect should be assessed from different angles. An institution could verify compliance by holding regular audits of the internal assessment and decision-making culture. In cases where institutions have adopted the moral-ethical declaration contained in the Banks Code, they could test adherence to it on the basis of the Seven Elements. Annex I lists a number of activities that financial institutions could perform in order to promote the Seven Elements of a values-led corporate culture.

4 THE SUPERVISORY RELATIONSHIP

The best way for DNB to effectively and efficiently tailor its supervision to influencing and monitoring behaviour and culture within firms is to link into the general procedures within supervision as exercised by DNB. One of the key principles in DNB’s regime is risk-orientation, implying that the supervisory resources are applied where the risks are greatest.
In addition, the supervisory framework is based increasingly on principles rather than rules. This affords an institution more freedom to achieve compliance in accordance with its own views.

The key idea is that differences in risk characteristics lead to variation in the supervisory approach: the level of DNB's involvement depends on the degree to which the institution has its processes under control[8].

DNB may also base its supervisory activities directed at a firm’s internal culture on the supervisory model outlined below. The bottom line is that the atmosphere surrounding a financial firm, both in its internal and external operations, influences the supervisory relationship; the intensity and nature of supervision is aligned to the maturity of its corporate culture. Important distinctions are whether firms are aware of the standards, whether they are able to comply with them, and whether they are willing to do so.

It is clear from this supervisory model that DNB can only take on a role of an ‘advisor’ if an institution has adequately internalised the concept of an ethical culture. However, this also means that the level of supervision applying to a particular institution must be clear within DNB. For one, it must be realised that even in the case of firms that are subject to minimum standards, principles-based supervision and the concept of comply and explain, DNB is still free to supervise ethical behaviour and culture, the basic premise being the adoption of integrity as an internal norm.

[8] See DNB Supervisory Strategy 2006-2010, p. 16.

Growth model to apply to individual institutions

Corporate culture/values	Supervisory relationship
Minimum standards • Compliance influenced by perceived chance of being found out or sanctioned • Mechanical compliance with laws and regulations • Tries to abdicate responsibilities	**Enhanced supervision** • Giving concrete instructions • Increasing perceived chance of being found out • Direct, effective, consistent sanctions • Shaming/disclosing
Compliance culture • Options for compliance or non-compliance influence the degree of compliance • Reliant on guidance • By the book • Unaware of some risks • Bureaucratic	**Supervising/educating** • Themed/focused supervisory visits • Providing information • Giving ideas, guidance • Reducing red tape • Making compliance commercially attractive
Beyond compliance • Social environment/checks between organisations promotes integrity • Risk focused, self policing • Ethos integrated into most business processes • Ethos seen as assisting business	**Educating/consulting** • Open contact • Reminding firms of their social responsibility
Values-led business • Internalise integrity • Spirit of the law • Professional individual responsibility • Focus on prevention • Focus on learning • Awareness and discussion of ethical considerations at all levels • Open culture	**Benchmarking** • Interaction with firm/sector in devising policies • Leading by example • Trust in the supervisor • Explaining the "why" of standards • Creating champions, faming • Supervisor as advisor

5 ACTION PLAN 2010 - 2014

Conduct within firms may be influenced by positively reinforcing desired behaviour and eliminating undesired behaviour. The Seven Elements lead to several possible actions, including:

- assessing the decision-making process (balancing of interests; transparency, etc.);
- assessing the final decisions (against the firm's own objectives and principles);
- identifying inconsistencies in the objectives or principles and the corresponding operational decisions and necessary transparency; and
- more focus on human behaviour and how this is influenced (what incentives play a role in the decision-making process: rewards, pressure, status).

In performing the above actions, DNB has several options. To influence behaviour and culture and assess to what extent an ethical culture is embedded in an organisation, DNB may choose from the tools employed for direct supervision, or more indirect activities. Every activity in this context should in any case be performed cross-sectorally in order to create a level playing field.

In the coming period, DNB will apply a mix of instruments. In vetting directors and members of the supervisory board, DNB will place more emphasis on integrity and financial expertise. In addition, supervisory examinations – with regard to all prudential risks- will structurally address culture, behaviour (and perverse incentives), e.g., by focusing on an annual theme (one of the Seven Elements of a values-led corporate culture).

DNB has already highlighted behaviour and culture through speeches, press releases and other forms of external communication. It will continue to do so over the next years. DNB also supports initiatives to make ethics, integrity and compliance an integral part of the training for auditors, economists, lawyers etc.

To test the effectiveness of these instruments, it would be advisable to apply them in the light of the supervisory model described in the previous section.

De Nederlandsche Bank Eurosysteem

Annex I: Elements of an ethical corporate culture

The "What?" column in the table below gives further details on the elements of an ethical corporate culture. The "How?" column lists some of the activities a financial firm should perform to ensure it promotes an ethical culture. DNB understands an ethical culture as one in which professional, individual responsibility is encouraged and rewarded; a culture in which people act in line with the spirit of the law.

Elements	What?	How?
Balancing of interests/ balanced actions	o Taking stakeholders' interests seriously o Risk analyses of customers, products, employees, processes and activities in order to identify all relevant interests/risks o Keeping a record of considerations	o Self-assessments of ethical conduct, with input from the second line of defence/HR leading ▪ to insight into critical processes/positions and their practical application and ▪ to an understanding of the leading social norm within the group o Regular, critical examination of the assessment and decision-making structure o Training and communication on conscientious moral judgement o Promoting diversity
Consistent actions	o Clear objectives and principled choices, stating reasons o Consistent actions in line with objectives and choices	o Referring back to objectives when making decisions on products, interest rates, remuneration schemes, etc.
Openness to discussion	o Stimulating a positive, critical attitude among employees o Giving scope for discussing decisions, other views, mistakes and taboos.	o Involving and rewarding involved employee with decision-making process o Rewarding creativity and initiative o Training on dilemmas, promoting openness and discussion between employees o Employee satisfaction survey o Promoting diversity
Leading by example	o Showing personal integrity by: ▪ standing up for standards and values	o HR policies, MD program leading to managers who encourage employees to behave ethically, protect them against

	▪ balancing interests conscientiously (content and process) ▪ being consistent and transparent in word and deed o Preventing the (appearance of) a conflict of interests o Propagating the firm's core purpose and values	non-ethical behaviour and take action to counter it o Explicitly allocate monitoring competencies in the second line o Willingness to be open about private circumstances o Openly 'embrace' i.e. recognise and weigh up conflicting interests o Link status to the firm's basic values
Feasibility	o Setting realistic targets o Removing perverse incentives and temptations	o Rewarding professional (positively critical) behaviour o Gaining insight into internal standards and base management on suitable incentives
Transparency	o Communicating to all stakeholders in an accessible form o Showing that you are consistent in your actions	o Saying who you are and what you stand for through advertisements, websites, product descriptions o Annual report and other publications
Enforcement	o Attaching consequences to non-compliance	o Raising employees' awareness of the effects of their behaviour o Giving direct feedback on results of behaviour o Carrying out random internal controls