Remarks by
Julie L. Williams
Acting Comptroller of the Currency
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It's a great honor to be a part of this distinguished forum. This year's program, which offers a remarkable number of stimulating papers and engaging presenters, carries on the tradition of high standards of scholarship for which this Conference is, justifiably, renowned.

In my remarks today, I would like to continue the theme – perhaps this will evolve into another tradition – begun at last year's conference by Doug Roeder, the OCC's Senior Deputy Comptroller for Large Bank Supervision – of exploring risk management issues involving large banking organizations. Last year, Doug addressed how risk management by large financial institutions has evolved. He described how our largest banks now use sophisticated quantitative techniques to help them model alternative risk scenarios, and how Basel II creates new incentives to develop those systems.

Doug also spoke about how our largest banks use well-established secondary loan and derivatives markets where credit risk can be mitigated, and how they have been able to achieve a high degree of diversification in their product lines and loan portfolios. He also described how our country's largest banks employ staffs of risk management specialists, who can deliver a level of expertise far exceeding that of a decade ago.

Today, I'm going to come at the topic of risk management by large banking organizations from a different angle. First, I will focus on today's most elusive, difficult to manage and perhaps most feared risk: reputation risk. Second, I'll talk about large banking organizations' management of reputation risk from the perspective of what corporate functions, checks and balances the OCC, as a bank supervisor, is looking for. Lastly, I'll talk about the role of ethics and corporate values.

Why reputation risk? According to a recent PricewaterhouseCoopers survey, senior risk managers in 134 banks said that reputation risk was, overall, the biggest risk they face. In terms of market value of their companies, reputation risk came in # 1. As a threat to earnings, reputation risk ranked # 6 – although I have to wonder if the compliance experiences of several large companies during the past year might result in a higher ranking if the survey were taken today.

In a way, the prominence of reputation risk as a concern also is a product of large banks' successes in managing other types of risks. The impressive progress they have made in managing credit, market, and interest rate risks – as Doug Roeder described in his presentation last year – has enabled them to weather the recent recession with steady growth in record earnings, without compromising fundamental safety and soundness. These successes make ethical and compliance embarrassments even more conspicuous and damaging to an organization's franchise.

Recent years offer plenty of evidence of reputation risk crises that have resulted in casualties in the executive suite; lawsuits and even indictments handed down; employee morale suffering; new legislation; supervisory oversight stepped up; headline-grabbing fines; and some strategic initiatives abandoned or postponed. We're speaking now about some of the most familiar and respected brands in the financial services business – institutions that were enjoying some of the best years in their long histories, at least from a strictly profit measure. Clearly, reputation risk has real, tangible negative impacts on a banking organization.

So, what does the OCC expect of large banking organizations? How can the OCC possibly evaluate how large, diverse and complex banking organizations manage reputation risk?

First, we don't look at reputation risk in isolation. We look at whether a bank has an environment for sound decision-making that includes effective structural governance and a system of checks and balances to identify, monitor and control the risks to which the organization is subject. And when it comes to reputation risk, part of that environment is whether the organization's incentives recognize and reward the corporate values and culture that the company wants to promote.

While we really don't "regulate" corporate ethics, we can and we will notice and comment on whether a banking organization has a corporate organizational framework, and policies or practices that support – or undermine – sound corporate values and an ethical climate within the organization. It is our experience that if such values and the *ethos* of the organization are not strong, institutional soundness and a bank's good name and reputation can suffer in unpredictable ways.

Let's start with some of the basics of effective structural governance and checks and balances. When we look at large banking organizations, we expect to see some form of risk management function and accountability *within* each major line of business. Many of the largest banking organizations also have company-wide risk management functions that are very robust and sophisticated and that provide an enterprise-wide perspective on risk throughout the organization. We do not dictate to national banking organizations that one or the other type of risk assessment function should predominate over the other. But we do absolutely expect that the combination will be an effective risk management function for the organization's lines of business.

For example, our examiners will note what activities and risks exist within a line of business and would be sensitive to the *quality* of risk management for how that business is conducted. Does the line of business risk-assess the activities and transactions it conducts, and is the quality of risk management commensurate with the level of risk taken? Does it apply more diligence and tighter controls in its high-risk areas? What external indicators are taken into consideration to identify risks? In a retail line of business, examiners might begin by looking at the institution's customer complaint function – an excellent window on the bank's commitment to the quality of its customers' banking experience. The best companies have quality assurance programs in place that track and analyze their customer complaint experience and flag unusual trends. And what becomes of that information? Are managers held accountable for acting on the information and improving performance? What process exists within the business line to check to verify what follow-up has occurred?

We look at the compliance management function, to see whether it is properly resourced, has adequate stature and influence within the organization, and has adequate access to senior management and the Board. Has the compliance function been effective in protecting the bank by identifying practices that fail to comply with law or regulation? Are activities that fall into gray areas that are not clearly noncompliant also flagged? Is that information being brought to the attention of business line or enterprise-wide risk managers, who are in a position to take appropriate and decisive action?

Next comes the role of an organization's internal audit function. Here we look for a robust and *independent* internal audit function. We make this determination through a combination of discussions with bank audit management and personnel, review of audit schedules, reports and workpapers, and assessments of audit follow-up activities.

We pay particular attention to the degree to which audit testing of internal controls is conducted for financial management and key business lines. In addition, examiners review management's annual assessment and attestation of the effectiveness of internal controls to verify the reliability and accuracy of management's assertions. When deficiencies are noted in the bank's audit function, examiners will require prompt corrective action to remedy critical deficiencies. If necessary, examiners may conduct additional validation or discovery work that includes testing of internal controls in high risk or high growth business units.

Essential to independence is the reporting line of the internal audit function. Does it have unfettered access to – and the full support of – senior management and the Audit Committee of the Board? One way we measure that support is whether the internal audit staff is of adequate size and is headed by individuals of appropriate rank and stature within the organization to give that function the credibility and weight that its recommendations need. We also try to make sure that internal audit is not subject to cost pressures that might compromise its effectiveness, and that it provides sufficient information to the Audit Committee so that the Audit Committee understands issues and can ensure that management takes all necessary actions.

External auditors also have an important role. We don't rate a banking organization's external auditors, but we do notice, and, where notable, we will comment directly on what we perceive to be their contribution to the organization's overall risk management processes. Again, our focus is on the independence, as well as the competence, of the external auditors. We assess whether the company appropriately oversees its external audit program, addressing findings in an adequate and timely manner. We also determine what relationships, including non-audit services, the external auditor provides in addition to statutory financial statement audit and attestation requirements. And we hold discussions with the external auditor on how it ensures that employees who are responsible for auditing the bank do not have relationships that compromise their independence.

Another perspective we look at is how risk-related information flows between the different functions, especially whether it flows up to senior management. How does vital information get to the bank's Audit Committee? Risk Committee? Board of Directors? And do the key corporate managers and committees probe the representations they receive about how the business is doing? "Trust, but verify," is the mantra of bank examiners; it should also be the mantra of bank risk managers and directors. If it isn't, we will notice it.

An aspect of information flow that is of particular concern to us (as you might expect) is how issues being raised by *bank supervisors* are communicated to appropriate corporate committees, and through them, to the Board. Is critical supervisory information being "capped off" by senior management so it doesn't get to the Board? Is there a good, open and constructive dialogue on supervisory issues between the banking organization and the regulator, including at the Board level, or do we have to "write up" an issue as a "matter requiring attention" in an exam report in order for it to get attention and response?

We believe that most bankers will make good decisions if they have good information – from their own risk control processes and from their regulator – and that bad decisions are more likely than not the result of incomplete, unduly influenced, misleading, or erroneous information. This is why examiners focus on the quality, integrity, and timeliness of management information systems on a consolidated firm-wide basis, *and* at the business-line level. Robust management information systems that are comprehensive and designed as early warning systems should help risk managers keep their finger on the pulse of emerging reputational risk within their organizations.

All these functions – business line risk management, enterprise risk management, compliance management, and internal and external audit, supported by effective internal information flow and communication – are vital components of a banking organization's "defensive line" against reputation risk. But that defensive line of corporate functions will be fundamentally incomplete if the organization is not grounded in a sound corporate culture and value system understood by all its employees.

This is a challenge that is not unique to banking organizations. Perhaps what we are experiencing in parts of corporate America today is the modern-day manifestation of the divorce of private and corporate morality that historian Arthur Schlesinger jr. observed in his masterful history, The Age of Jackson. There, he described the rise of the corporation as the dominant mode of business organization in 19th Century America, and the development of corporate morality: As perceived by Schlesinger, "[s]lowly private morality and business morality grew apart. Slowly the commercial community developed a collection of devices and ceremonials which enabled businessmen to set aside the ethic which ruled their private life and personal relations."

It is telling to recall, that it was in that age, as business morality was perceived to skid away from the standards of private morality, that government felt obliged to insert its authority, and it was Jackson's presidency that saw the first manifestation of government regulation – an early attempt to reverse that slide and *impose* a version of public morality on the business sector.

Returning to the present day, a key question large organizations face was cogently stated by Amy Brinkley, Chief Risk Executive of Bank of America, in a speech last year to Wharton Business School graduates. She asked: "How do you hardwire values and ethics into the character, the very DNA, of a company?"

No question is more central to the ability of a large banking organization to manage reputation risk. All the corporate committees, cross-checks and management reports in the world won't offset a sour environment of corporate values and ethics.

And what is the role of bank regulators in this? As I said before, we don't "regulate" corporate ethics, but we can and we will question policies or practices that undermine sound corporate values and an ethical climate within a banking organization.

For example, how do a company's incentives tilt? Are compensation programs rewarding the behavior that the organization wants to incent, rather than motivating other behavior? What factors go into compensation decisions? Are employees rewarded based on both the *quality* and quantity of what they do? Is success in dealing with compliance and reputational issues a factor in determining *executives'* compensation. A "best practice" we have seen in some banking organizations to ensure that compensation arrangements are supporting the behaviors an organization wants to encourage, is participation of one or more directors from the organization's Audit or Risk Committees on the Compensation Committees, and vice versa.

More than anything else, compensation must be keyed to the interests of the company – to its safety and soundness, broadly defined – rather than to its short-term profitability or growth. And when conflicts arise, as they're bound to, between the various stakeholders in the company, particularly among various business lines, on the one hand, and the risk management and compliance functions, on the other, it's crucial that senior management resolve those conflicts in a way that sends an unequivocal message about its ethical and reputational priorities.

We sometimes observe this issue playing out in the new product approval process. If the business line representatives are insufficiently sensitive to the reputational or compliance risk that a new product entails – or if risk management's views about the dangers of a particular new product are repeatedly overridden in the process – it may suggest a weak ethical culture, a misaligned incentive structure, and an enterprise in which employees are motivated to act single-mindedly in pursuit of revenue and profit growth without regard to integrity and the reputational interests of the company.

Where these factors exist, we would have concerns that the organization is vulnerable to a reputation risk "shock."

Finally, nothing could be more vital to the ethical climate of an organization than the example set by it leaders – the "tone at the top." While we generally do not dictate particular conduct here – except, of course where an individual's conduct violates a law or rule or misuses bank resources – we would note if the behavior of senior management is not supportive of the articulated goals and values of the organization. Does the organization have a Code of Ethics and written policies that reflect risk tolerances of the Board? How is this communicated throughout the organization to ensure employees at all levels of the organization have a clear understanding of expected ethical behavior and risk tolerance? Once communicated, does senior management lead by example and take ownership of ethical standards in the conduct of their business?

We not only look to senior managers to set the right tone; it's also their job to enforce it. Accountability is key. Ethical companies not only reward ethical behavior; they penalize misbehavior. Spending resources on good control systems, good customer service, and employee incentives may well be the simple part. It's sometimes much tougher to restrain a top producer whose zeal could compromise the bank's integrity and reputation. But senior managers know that the failure to take that step – and the other actions that I've discussed today – could place them and their institutions' reputation – and its franchise – at risk.

In closing, and stepping back, it's important to recognize that no one is perfect – including large corporations – and that in any organization, large or small, there will always be the potential for mistakes and misjudgments. That potential increases as organizations get larger, and particularly so, if, as a result of competitive pressures, employees are pressured or incented to pursue profits at any cost.

The types of structural governance and checks and balances I have described are vital to sound governance and important protections against reputation risks. But, the ultimate protection for banking organizations, and for the people responsible for running them, is to instill in all employees a dedication to high standards of fairness and ethical dealing; to make clear throughout every corner of the organization, that no deal, no sale, no loan, no customer, and no profit opportunity, is worth compromising the bank's good name and reputation.

Thank you.