

Citi Internal Audit

Auditing Conduct, Culture and Ethics: From Abstract Concepts to Tangible Results

Ira Goldberg

Chief Auditor, Compliance & AML

Pablo Ottado

Chief Auditor, Global Consumer Banking

Agenda

1. Thinking About Culture, Conduct, and Ethics
2. Regulatory Landscape & Role of Internal Audit
3. Principles for Structuring a Program for Auditing Culture, Conduct, and Ethics
4. Scoping and Strategy for Executing Culture, Conduct, and Ethics Audits
5. Incorporating Behavioral Science
6. Commonly Asked Questions

Thinking About Culture, Conduct, and Ethics

Culture and Conduct - Definitions

The following slide provides definitions of Culture and Conduct, and the importance of applying an ethical lens to assessing Conduct and Culture risk.

What is Culture?

Culture is a shared set of ideas, beliefs, attitudes and customs.

What is Conduct?

Conduct is behavior. An ethical culture tends to result in generally ethical behavior, although there can be outliers, while a less ethical culture can result in pervasive misconduct.

Applying the Ethical Lens

When auditing for Culture and Conduct risk, the analysis should not stop at a determination that no law has been broken or policy violated. Auditors should also ask whether the activity is the right thing to do to reinforce the firm's values and desired culture.

Key Definitions

- Culture
- Conduct
- Ethical Lens

Auditing Culture, Conduct, and Ethics

Auditing Culture, Conduct, and Ethics requires a unique approach.

Reporting

Governance reporting and issue escalation at all levels is needed for management and boards to provide appropriate oversight of culture and conduct risk.

Subjectivity

Employing the ethical lens necessarily requires a great deal of judgment in gray areas. Auditing culture requires skill and comfort analyzing the qualitative aspects of information. Auditing conduct also requires the ability to analyze qualitative aspects of information as not all breaches represent misconduct.

Scope

Risks pertaining to ethical culture and conduct can occur anywhere in an organization.

Key Definitions

- Reporting
- Subjectivity
- Scope

Regulatory Landscape & Role of Internal Audit—Pertaining to Financial Institutions

Regulatory Landscape for Financial Institutions

Regulatory focus on Culture, Conduct, and Ethics continues, and is growing due to recent scandals, including benchmark rates and sales practices.

Historic Focus

Culture and conduct have never been more prevalent in the minds of financial services regulators.

Growing Emphasis

Since 2008, the volume of guidance has grown significantly, and has been accelerating from 2014 to today.

Recent Events

International Regulatory focus on Culture, Conduct and Ethics.

Landscape

- Historic Focus
- Growing Emphasis
- Recent Events

Regulatory Landscape Timeline for Financial Institutions

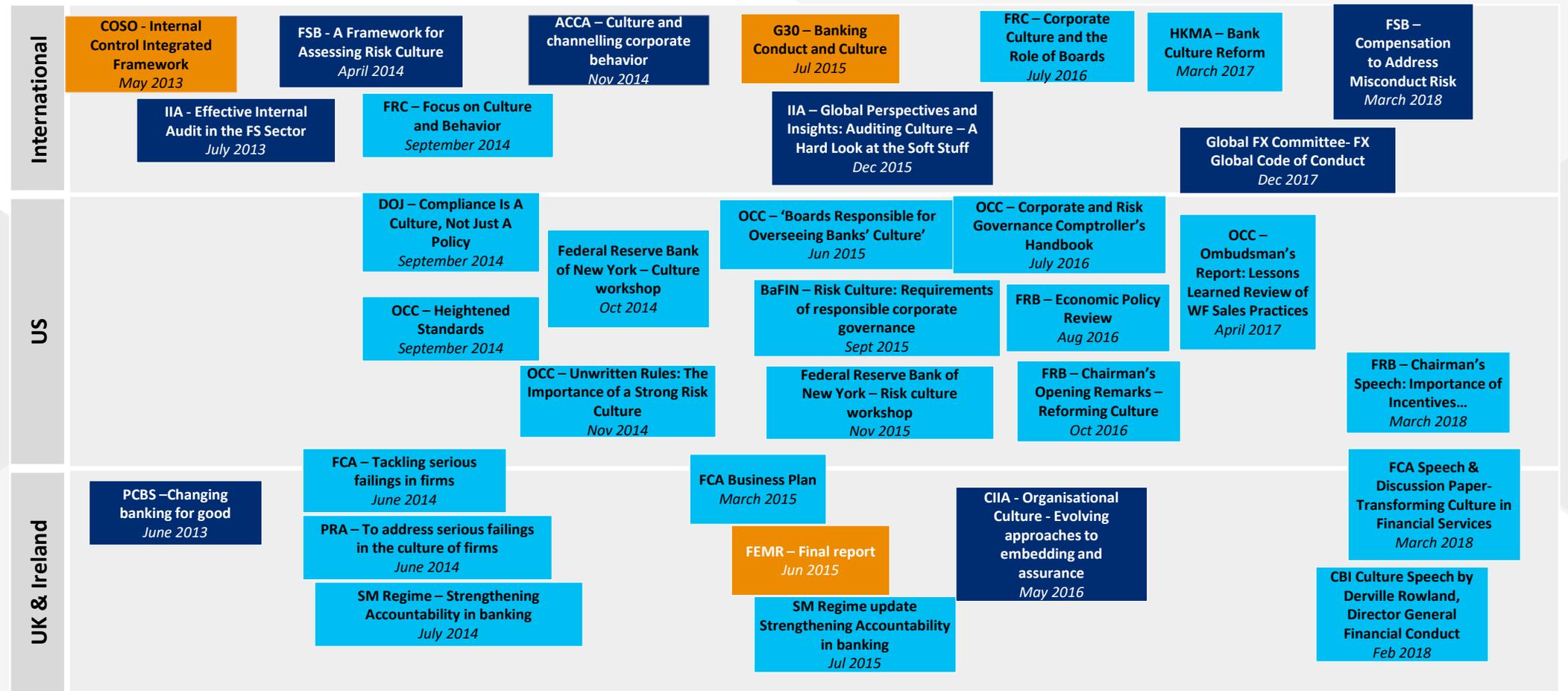
This slide illustrates a summary timeline of the key regulation and guidance that have been released. A critical component of the design and scoping of culture and conduct audit programs should include an evaluation of and alignment to key foundational elements identified by applicable regulators.

Key

Regulatory guidance

Governing body guidance

Other industry guidance



Hard Regulatory Requirements: Auditing Culture, Conduct, and Ethics

Few regulatory bodies have established “hard” requirements for auditing culture and conduct, yet financial services regulatory actions evidence an increased focus on culture and conduct, and could be considered “hard” requirements. Most financial services regulators have “soft” requirements such as speeches and other guidance which are noted on the next slide.

Key Publications

- OCC
- HKMA
- IIA

Hard Requirements	
OCC ₁ (US)	<p>OCC 2016-25: “Internal audit plays an important role in monitoring the effectiveness of the bank’s ethics program and whistle-blower policy. Internal audit should assess the bank’s corporate culture and standards and ethics processes to identify any governance-related weaknesses. Internal audit should assure the board that suspected fraud and <u>misconduct are promptly reported, investigated, and addressed.</u>”</p>
HKMA ₂ (Hong Kong)	<p>“The board and senior management of an institution should, in their respective roles, set an appropriate “tone from the top” and lead by example....The board-level committee, assisted by internal audit functions or other experts where appropriate, should introduce a regular process to review and confirm the effectiveness of the overall culture enhancement initiatives pursued by the institution. In particular, the committee should approve, review and assess, at least annually, the adequacy of any relevant statement which sets out the institution’s culture and <u>behavioral standards</u>, and seek to ensure that such statement is <u>translated into policies and procedures (including training)</u> that are relevant to the day-to-day work of different levels of staff;”</p>
IIA ₃	<p>“Auditing culture must be incorporated into every audit engagement, providing the organization with a baseline for continuous monitoring and enabling internal auditors to look for early warning signs.”</p>

Source:

- 1 <https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-crg.pdf>
- 2 <http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170302e2.pdf>
- 3 <https://global.theiia.org/knowledge/Public%20Documents/2016-Feb-GPI-English.pdf>

Soft Regulatory Requirements: Auditing Culture, Conduct, and Ethics

Soft regulatory requirements and expectations for financial services internal audit coverage of Culture, Conduct, and Ethics are below.

Soft Requirements	
<p>MAS₁ (Singapore)</p>	<p>“Financial institutions can expect MAS to engage them more regularly on what they are doing within their own organizations to shape the right culture. We . . . look beyond . . . a compliance and control framework to assess if financial institutions have a supporting culture that <u>incentivizes their employees and agents to do the right thing, rather than just doing what’s legal.</u>”</p>
<p>FINRA₂ (US)</p>	<p>“Culture will continue to be an important driver in FINRA’s regulatory programs. [In exams we] count culture as a factor that influences a firm’s risk profile . . . culture . . . [can impact] the probability or severity of an enforcement action. “</p>
<p>FSB₃ (Global)</p>	<p>“...business lines, the risk management function, compliance, internal audit and other control functions have clearly delineated responsibilities in regard to monitoring, identification, management and mitigation of risk. Accountability speaks to the prompt identification, management, and escalation of emerging and unexpected risk issues, and having a clear understanding of the consequences for not doing so, while retaining day-to-day operating management of risk with the units originating them.”</p>
<p>FCA₄ & 5 (UK)</p>	<p>FCA’s annual conduct meeting with firms, they assess “How do[es] internal audit . . . encourage . . . front, middle, back office, <u>control and support functions to feel and be responsible for managing the conduct of their business?</u>” A FCA speech noted, “because senior management cannot be watching everything all the time, there need to be effective systems and controls to ensure the business is operating effectively and in accordance with standards of conduct that have been designed and approved by senior management...What is needed is a risk-focused counterfactual or counterintuitive audit from the perspective of the cynic who is able to exploit the price of the system’s gaps.”</p>
<p>FRC₆ (UK)</p>	<p>“IA has the potential to be an important provider of assurance to the board alongside functions such as HR, and risk and compliance. Results can be reported informally or formally [reported].”</p>
<p>APRA₇ (Australia)</p>	<p>“There is increasing consideration being given to how risk culture can be incorporated in internal audits – both as a stand-alone review and as a component of all reviews. Internal audit teams were seen as having good exposure across all aspects of an institution, and as a good mechanism by which consistent and continuous assessments can be made. As a result, some organization's have begun programs in which internal audits include a report on cultural aspects of the business.”</p>

Source:

- 1 <http://www.mas.gov.sg/News-and-Publications/Speeches-and-Monetary-Policy-Statements/Speeches/2017/Culture-and-Conduct.aspx>
- 2 <https://www.finra.org/newsroom/speeches/052316-remarks-2016-finra-annual-conference>
- 3 <http://www.fsb.org/wp-content/uploads/140407.pdf>
- 4 <https://www.fca.org.uk/firms/5-conduct-questions-feedback/questions-2-5-observations>
- 5 <https://www.fca.org.uk/news/speeches/culture-and-governance>
- 6 <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Corporate-Culture-and-the-Role-of-Boards-Report-o.pdf>
- 7 <http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf>

Key Publications

- MAS
- FINRA
- FSB
- FCA
- FRC
- APRA

The Role of Internal Audit

Internal Audit (IA) plays a crucial role in assessing Culture, Conduct, and Ethics risk, as the third line of defense.

Ownership of the Risk

The Board and Senior Management have the ethical culture and conduct mandate.

Audit's Role

IA's role is to provide assurance to the board. The goal is to help the board determine whether culture and conduct initiatives are actually working.

Talk is Not Enough

Value statements and communications must be supported by concrete actions.

Principles for Structuring an Audit Program for Culture, Conduct, and Ethics Risk

Principles For Audit Coverage

Good audit coverage for Culture, Conduct, and Ethics requires flexibility, subjectivity, an ethical lens, reporting findings, and appropriate skillsets.

Key Aspects

- Agility
- Buy-in
- Ethical lens
- Escalation
- Expertise

- 1 Flexible coverage**
- 2 Subjectivity and management buy-in**
- 3 Applying an ethical lens to routine business and function audits**
- 4 Reporting to escalate culture, conduct, and ethics concerns**
- 5 Appropriate skillsets, including subject matter experts**

Emerging Best Practices

There is no one best way to audit Culture, Conduct, and Ethics as there are a variety of different approaches; however, organizations are increasingly focusing on enhancing their Internal Audit team and adopting a tiered approach similar to the following:

Tiered Approach

- Discrete reviews
- Component Reviews
- Thematic

Discrete reviews

- Standalone audits focusing specifically on Culture, Conduct, or Ethics.
- Should include both:
 - Horizontal/thematic reviews
 - Deep-dive reviews in a specific business or jurisdiction

Examples could include:

- Horizontal/group level culture and values audit
- Horizontal global conduct audit
- Culture program and/or conduct risk program audits

Component reviews

- Embedding consideration of Culture and/or Conduct in audits not dedicated to those risks.
- This is really the development of a strong SME function, since these risks and issues can arise in any audit, not just those specific to Culture or Conduct.
- Training is key to the success of this component.

Examples could include applying a culture and/or conduct lens to:

- Product audits
- Function audits
- Country audits

Thematic

- Consolidation allows for the outputs, from the various discrete and component reviews, to be collated, analyzed, and reported to management.
- This draws on findings arising from deep dive/targeted audits (depth) as well high level horizontal reviews (breadth).

Outputs include:

- Consolidation of the culture and/or conduct outputs from the discrete and component reviews
- Generation of metrics and identification of trends

Scoping and Strategy for Executing Culture, Conduct, Ethics Audits

Culture, Conduct, and Ethics Audits – Key Elements

Culture, Conduct, and Ethics risks can be assessed according to the Key Foundational Elements, listed below.

Key Elements

- 1 Leadership and Communication**
- 2 Governance**
- 3 Culture and Conduct considerations within the HR Lifecycle**
- 4 Escalation and Resolution**
- 5 Organization Structure**

Culture, Conduct, and Ethics Audits – Key Elements (Continued)

Key Elements

6	Oversight and Governance
7	Risk Appetite Framework, Taxonomy, and Metrics
8	Customer Complaints
9	Customer Fairness
10	Market Activities and Practices
11	New Product or Services

Risk Considerations – Additional Factors

This slide provides risk considerations that could drive frequency of coverage and dynamic audit planning.

Key Aspects

- Nature
- Jurisdiction
- Current Issues
- History
- Structure

1

Nature of Business – Is the business one that might tend to be higher risk for culture or conduct? This might include businesses that have intense focus on sales/numbers that can be impacted/inflated by misconduct.

2

Jurisdiction – Some jurisdictions are more prone than others to these risks, so the inherent risk might be higher. Likewise, some jurisdictions have an increased regulatory focus, so the enforcement risk may be higher.

3

Current Identified Issues – Take a look at the current portfolio of outstanding management raised, audit, and regulatory issues for the audit entity.

4

History – Look at the medium-term history for the audit entity holistically. Consider trends.

5

Organization Structure – Consider the strength of oversight for the audit entity.

Incorporating Behavioral Science

Culture Behavioral Assessments

Auditors should consider incorporating behavior assessments as part of their audits for Culture, Conduct, and Ethics. This will enable audit teams to better assess whether Senior and Middle management fosters an environment commensurate with the organization's values.

Ongoing Activities



Employee Culture Surveys

Employee culture surveys can provide key insights on effectiveness of the **"Tone at the Top and Middle"** by measuring **"Echo from the Bottom."**

- CONFIDENTIALITY is key to obtain candid responses.
- AUTOMATED survey tools can reach the full employee population.
- SUPPORT of management to reinforce the importance of the survey is key to a high participation rate.



Leadership Behavior Assessments

Assess management's impact on culture and further measure **"Tone at the Top"** by identifying key leaders for behavior assessment.

- A THIRD-PARTY FIRM with psychologists and experience in culture assessments can bring specialized skills and objectivity to the assessment.
- PERSONALITY ASSESSMENTS, LEADER INTERVIEWS can directly measure leaders' impact on culture.
- 360 FEEDBACK can provide insights on the leader's footprint across the organization.



Audit Reporting and Roundtables

Include results of the Surveys and Leader Assessments in the **Audit Report**, and **obtain Management's Corrective Actions** for any areas identified for improvement.

- ROUNDTABLES with Leadership to discuss aggregated findings, and facilitate leaders; brainstorming to identify Corrective Actions.
- CORRECTIVE ACTIONS for findings should include implementation of management's actions and ongoing measurement to assess improvements.



Culture, Conduct, and Ethics Audit – Example Scope

3 Areas of Assessment



Promote

- Citi's **culture and values** is promoted through behaviors, actions and words.
 - ✓ *Review management communications/town hall meeting decks and key governance forum meeting minutes.*
- Key culture and value topics are reinforced through **trainings**.
 - ✓ *Review key training materials for coverage of culture topics and completion rates of U.S. Consumer Bank employees.*



Monitor

- **Issues/incidents** are monitored for prompt and effective **escalation** to applicable governance forums, are **resolved** timely, assessed to determine the **root cause**, and a **thematic analysis** is performed to identify trends.
 - ✓ *Review of key governance forum meeting minutes and issue/incident reports.*
- **Sales goals** are analyzed to identify inconsistent or outlier sales goals and whether goals are in conflict with **customer fairness objectives**.
 - ✓ *Review of sales goals.*
- **Employee behavior** is monitored to identify instances of **misconduct** and employees are appropriately impacted.
 - ✓ *Disciplinary actions for substantiated misconduct aligns to the severity of the breach and is consistent with similar breaches and appropriately feeds into key Human Resources lifecycle events (performance assessments, compensation, and promotions).*



Knowledge & Awareness

- **Employees** sufficiently demonstrate an **understanding of Citi's culture and values**.
 - ✓ *Employee culture surveys and leader assessments*

Commonly Asked Questions

Commonly Asked Questions for Auditing Culture, Conduct, and Ethics

Below are questions that typically come up as auditors plan, scope, execute, and issue audit reports for Culture, Conduct, and Ethics:

Common Topics

- Challenges
- Approach
- Red Flags
- Elevated Risk
- Timeline
- Escalation



1. Is it Internal Audit's **role** to audit Culture?



2. How can Internal Audit **measure** and **opine** on Culture?



3. What are the biggest **challenges** to executing a Culture, Conduct, and Ethics audit.



4. What's the best **approach** to scope a Culture, Conduct, and Ethics focused audit?



5. What are **red-flags** that may drive a targeted audit on Culture, Conduct, and Ethics risk?



6. How does the **timeline** and level of effort for a Culture, Conduct, and Ethics focused audit compare to a more traditional audit?



7. What type of issues should be immediately **escalated** to those charged with governance, external auditors / stakeholders, and/or regulators?



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