VALUE AT RISK

A LOOK AT BANKING'S USD 850 BILLION BEHAVIOURAL PROBLEM

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QUINLAN
&ASSOCIATES

THE AUTHORS

BENJAMIN QUINLAN
CEO & MANAGING PARTNER

YVETTE KWAN
COO & PARTNER

HUGO CHENG
CONSULTANT

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CONTENTS

EXECUTIVE SUMMARY

The reputations of many of the world's leading banks took a severe hit during the Global Financial Crisis (GFC). The widespread sale of risky residential mortgage-backed securities (MBS) and collateralised debt obligations (CDOs) ultimately led to the collapse of several prominent Wall Street names and imposed significant costs on the entire industry.

With global banks forced to write down USD 300 billion in MBS assets, many questioned what had caused the crisis to materialise and how future losses could be avoided. But the scandals continued, including rogue trading and market manipulation. As a by-product of these incidents, regulatory scrutiny intensified, with US and EU authorities alone levying USD 342 billion in fines on the largest 50 banks since 2009, a number we expect to top USD 400 billion by 2020.

The international regulatory framework has also been significantly strengthened since the GFC, underpinned by Basel III, the Dodd Frank Act, and the soon-to-be-introduced MiFID II in Europe, as well as a host of local legislative provisions. To comply with these regulations, banks have invested heavily in their compliance and control functions, with compliance spend at many firms more than doubling since 2009, with investments being made in additional headcount, technology enhancements, and the restructuring of risk and compliance departments.

It is widely recognised that the root cause of the GFC can be traced back to the banking industry's high-risk, high-reward culture. Incentives focused on short-term gains, a tolerance towards unethical behaviour, and a lack of personal accountability, appear to have driven excessive risk-taking across the financial industry. We estimate this 'bad behaviour' has wiped off over USD 850 billion in profits for the top 50 global banks since the GFC in the form of write-downs, trading losses, fines, and additional compliance costs. If we also consider indirect impacts such as goodwill impairments, increased funding costs, reduced business activity from reputational damage and credit ratings downgrades, and legal fees, this number is likely to exceed USD 1 trillion.

In response to heightened levels of regulatory scrutiny, leading banks have focused considerable attention on bolstering their 'Three Lines of Defence'. However, actions taken to better manage risk since the GFC have mainly focused on lines two and three (i.e. risk and compliance, and internal audit). We believe many of these 'remediation' investments have been made at the expense of achieving meaningful change at the business unit level (i.e. the first line of defence). And it is not weak compliance measures or audit capabilities that have been behind this USD 850 billion P&L hit; it is bad behaviour and the absence of an effective front-line risk mindset.

If banks are serious about avoiding future fines and losses, we believe the solution lies first and foremost in developing a robust risk culture across the entire organisation. While inroads have no doubt been made to strengthen front-line accountability, including adaptations to governance and incentive structures, we feel an effective risk culture has failed to materialise across most firms. Many banks have also struggled to successfully shift the mindsets of their employees from rules-based to value-based behaviour, instilling a true sense of individual ownership with respect to risk. This problem is even more acute for many smaller, regional players.

We believe the most effective risk culture framework is one in which problems are addressed at their source; the first line of defence. Prevention, in our view, is always better than a cure. There is simply too much value at risk for such an approach to be ignored.

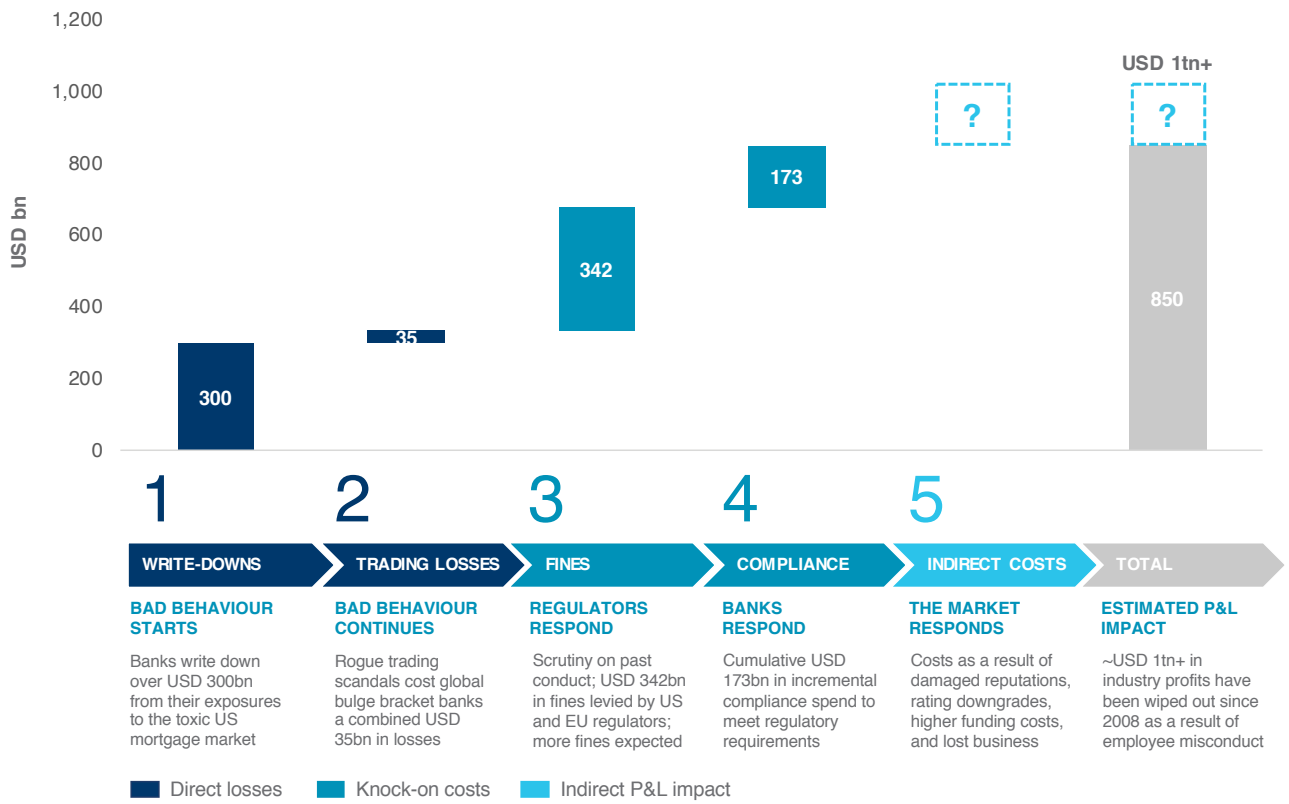
SECTION 1
THE COST OF BAD BEHAVIOUR

The GFC took a severe toll on the reputations of many of the world's leading banks, with the sale of risky MBSs and CDOs leading to the collapse of several prominent Wall Street names, including the likes of Bear Stearns and Lehman Brothers. The calamitous events of 2008, however, were only the beginning of what was to be a long and disastrous saga for many of the world's leading global banks, with the impact of widespread unethical behaviour that sparked the GFC having far-reaching implications on the profitability of the banking industry for the next decade. Not only did banks bear direct losses tied to employee misconduct (including subprime write-downs and various rogue trading losses), but they were also heavily impacted by numerous knock-on effects, including massive regulatory penalties and spiralling compliance costs.

Overall, we estimate employee misconduct has destroyed over USD 850 billion in industry profits from 2008 to present day. If we also take into account indirect costs such as goodwill impairments, increased funding costs, and reduced client activity as a result of reputational damage and credit ratings downgrades, this number is likely to top USD 1 trillion (see Figure 1).

THE CALAMITOUS EVENTS OF 2008 WERE ONLY THE BEGINNING OF WHAT WAS TO BE A LONG AND DISASTROUS SAGA FOR MANY OF THE WORLD'S LEADING GLOBAL BANKS, WITH THE IMPACT OF WIDESPREAD UNETHICAL BEHAVIOUR THAT SPARKED THE GFC HAVING FAR-REACHING IMPLICATIONS ON THE PROFITABILITY OF THE BANKING INDUSTRY FOR THE NEXT DECADE

FIGURE 1: P&L IMPACT OF EMPLOYEE MISCONDUCT



Source: Bloomberg, company reports, press releases, Quinlan & Associates analysis

DIRECT LOSSES

1. WRITE-DOWNS

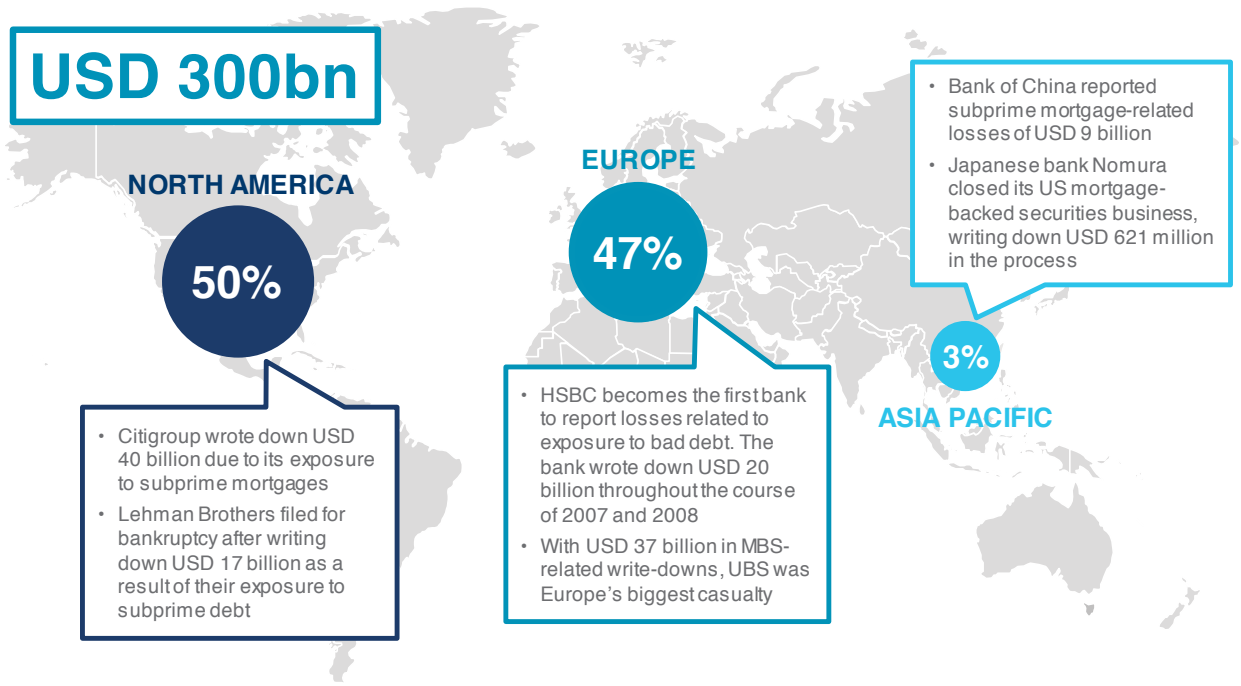
The GFC originated in 2007 with a crisis in the US mortgage market, where falling housing prices led to a sharp rise in mortgage default rates and a rapid devaluation of residential MBS.

The value of outstanding US subprime mortgages was estimated to have reached USD 1.3 trillion by the beginning of 2007. It was also in this year that the industry saw its first major casualty when, in February 2007, HSBC reported USD 10.5 billion of write-downs relating to their MBS exposure. By September, the crisis had spread across the world.

In Asia, Bank of China eventually wrote down USD 9 billion on its subprime mortgage exposure. In Europe, German banks IKB and SachsenLB were bailed out by the government, while Deutsche Bank wrote down USD 7.7 billion worth of subprime debt. UBS and Citi were the biggest casualties in Europe and the US, writing down USD 37 billion and USD 40 billion respectively.

Ultimately, banks globally were forced to write down USD 300 billion in subprime mortgage exposures (roughly equivalent to Hong Kong or Singapore's annual GDP), with the majority of this being borne by US and European financial institutions (see Figure 2).

FIGURE 2: GFC SUBPRIME MORTGAGE WRITE-DOWNS



Note: Numbers represent write-downs exclusively related to exposure to subprime mortgage market (by bank domicile)

Source: Press releases, company financial reports, Quinlan & Associates analysis

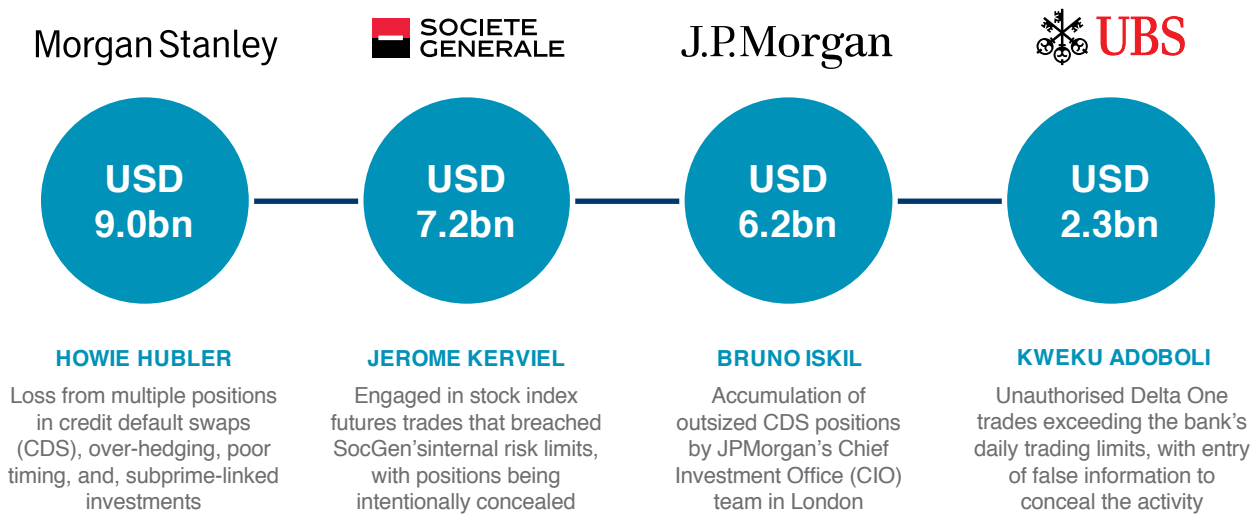
2. TRADING LOSSES

Against the backdrop of colossal write-downs, a handful of global banks found themselves caught up in large-scale rogue trading scandals.

Throughout the course of 2007-08, derivatives trader Jérôme Kerviel amassed a hidden stock index futures position of USD 73 billion at Société Générale (SocGen), significantly exceeding the bank's risk limits. Winding down the trader's portfolio cost SocGen USD 7.2 billion in 2008. In 2012, JPMorgan suffered a USD 6.2 billion trading loss in its synthetic credit portfolio as a result of the now infamous 'London Whale' scandal (see Figure 3). Such scandals pushed governments to implement legislation such as the Volcker Rule, prohibiting banks from engaging in proprietary trading activity.

We calculate that since 2008, the largest international banks suffered a total of USD 35 billion in trading losses stemming from rogue traders building up large and excessively risky positions whilst undermining internal risk and control systems. This number does not take into account the substantial fines banks were forced to pay as a result of these trading scandals.

FIGURE 3: MAJOR TRADING LOSSES



Source: Press releases, company financial statements, Quinlan & Associates analysis

Whilst improvements have been made to banks' internal controls, the cumulative trading loss is set to rise yet again this year. In July 2017, it was reported that Deutsche Bank could face a derivatives-related trading loss of up to USD 60 million following a bet on US inflation. It is currently being examined whether traders involved breached the bank's risk limits.

KNOCK-ON COSTS

3. FINES AND REDRESS

A raft of financial penalties have been handed out for a wide range of misconduct issues since the GFC, including the mis-selling of residential MBS, failing to adhere to Anti-Money Laundering (AML) regulations, and market manipulation.

In the US alone, the Department of Justice (DoJ) has handed out ~USD 73 billion in fines in relation to the creation and sale of toxic MBS, including fines of USD 7.2 billion and USD 5.3 billion for Deutsche Bank and Credit Suisse respectively. As recently as July 2017, RBS agreed to pay USD 5.5 billion to the Federal Housing Finance Agency to resolve claims related to the sale of toxic mortgage securities.

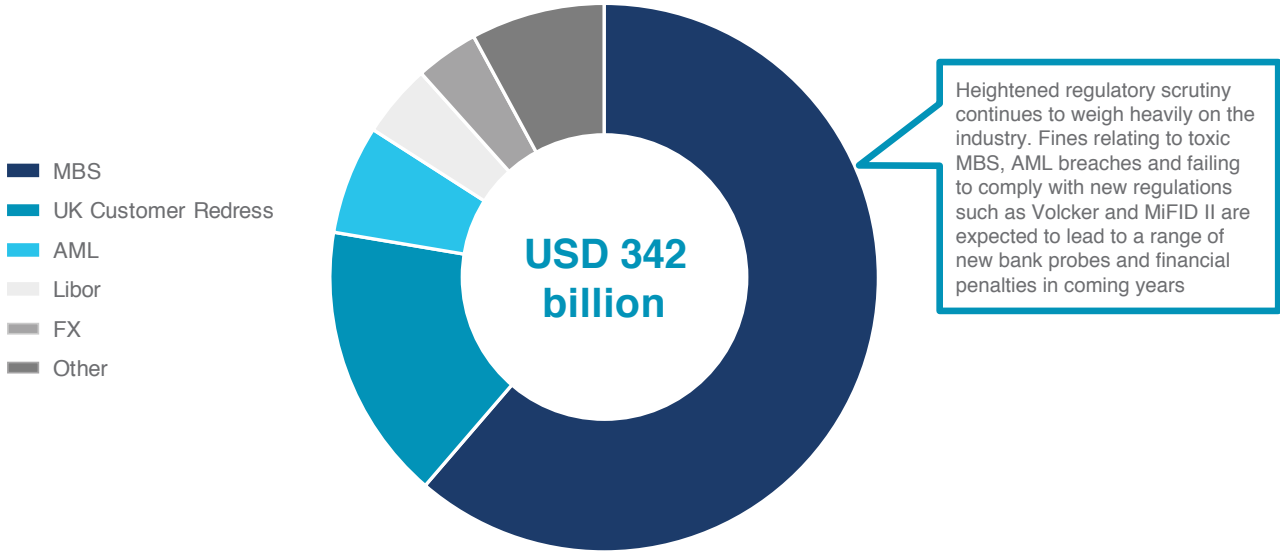
US regulators have been particularly aggressive in handing out fines for AML-related compliance failings, the majority of which relate to sanction breaches. In 2014, BNP Paribas was sentenced to five years of probation and paid a record USD 8.9 billion settlement for dealing with sanctioned countries. HSBC and Commerzbank similarly paid fines of USD 1.9 billion and USD 1.5 billion respectively, bringing AML-related penalties by US authorities to over USD 17 billion since 2009.

Market manipulation has also landed a number of global firms in hot water. The manipulation of the London Interbank Offer Rate (Libor) saw over a dozen banks hit with a combined USD 9 billion in fines, whilst the rigging of foreign exchange (FX) rates saw UK and US banks slapped with a combined USD 4.3 billion and USD 4.6 billion in fines respectively. Penalties have also been meted out for weaknesses in internal controls and oversight that resulted in large trading losses. JPMorgan, for example, was fined nearly USD 1 billion by US and UK prosecutors over its London Whale scandal.

In the UK, the mis-selling of financial products – from payment protection insurance to interest rate swaps – has resulted in at least USD 40 billion in combined fines and redress to customers. One of the more notable examples of mis-selling came in 2016 when Wells Fargo revealed that bank employees had opened an estimated 2 million fake accounts in an attempt to meet excessive sales targets. The bank was fined USD 185 million and in 2017 agreed to pay an additional USD 142 million to settle class action claims.

Overall, we calculate that USD 342 billion in fines have been levied on the top 50 global banks by US and European regulators alone since the start of the GFC (see Figure 4).

FIGURE 4: FINE AND REDRESS BREAKDOWN



Notes: the sample includes the largest 50 global banks. Data includes fines upward of USD 50 million that have been levied by US and EU authorities. UK customer redress includes banks' provisions for payment protection insurance and interest rate hedging compensation. AML includes sanctions on violations of US and EU anti-money laundering rules. Libor includes settlements on all interest rate products, including Libor, Euribor, and ISDAfix. Other includes, but is not limited to, fines for corrupt and discriminating hiring practices, dark pool trading fraud, misleading investors, illegal overdraft and credit card fees, and wrongful asset disclosure.

Source: Press releases, Quinlan & Associates proprietary estimates

Notwithstanding the massive scale of fines that have been handed out to the banking industry to-date, we believe the bloodbath is far from over. Legacy issues – including toxic MBS and tax evasion – continue to be targeted by investigators from different jurisdictions (see Figure 5). Despite the potential scale-back of some recent regulatory reforms in the US, we anticipate that AML, in particular, will remain a key enforcement priority, given ongoing concerns over terrorism across the globe.

FIGURE 5: EXPECTED FUTURE FINES

BANK	TYPE	AGENCY	FINE / PROVISION
Barclays	MBS / loans	US DoJ	USD 2.0 billion provision
CBA	AML compliance	AUSTRAC	AUD 22.0 billion in civil penalties
ING	AML compliance	Dutch AFM / US SEC	'Significant'
RBS	MBS / loans	US DoJ	USD 3.8 billion provision
UBS	Tax evasion	French AMF	USD 5.3 billion if case goes to trial

Source: Company annual reports, press releases, Quinlan & Associates analysis

In the meantime, enforcement of the new Volcker Rule has already found its first target. In April 2017, Deutsche Bank was the first bank to be hit with a USD 157 million fine for non-compliance with the ban on risky market bets.

The complexity and hefty reporting requirements of MiFID II, which takes effect in Europe on 3 January 2018, are also likely to give rise to a range of new bank probes and financial penalties as market participants try to get their heads around their compliance obligations. The sheer amount of data that will be collected will also allow authorities to conduct better analysis relating to potential non-compliance.

4. THE COST OF COMPLIANCE

As evidenced by the fines meted out to-date, banks have faced severe external pressure to change the way they operate and regain public trust. Despite a sharp reduction in risk-weighted assets and a simplification of business models, banks have spent a considerable amount of effort bolstering their compliance and control functions in response to the demands of regulatory authorities (see Figure 6).

FIGURE 6: EXAMPLES OF COMPLIANCE ENHANCEMENT AND SPEND

HEADCOUNT

citi

Regulatory and compliance H/C grew from 14,000 (1 in 23 staff) in 2008 to 30,000 (1 in 8 staff) in 2015

J.P.Morgan

Direct controls H/C grew from 24,000 (2011) to 43,000 (2015), accounting for 1 in 5.5 staff

Deutsche Bank

Additional 600 H/C in compliance and anti-financial crime team, to be scaled back to 400 (2017)

RBS

Majority of tasks for 2,000 know-your-customer (KYC) staff (2016) to eventually be automated

ORGANISATION

Bank of America

Compliance function moved from legal department, and aligned under risk management

UBS

Compliance function moved from Legal & Compliance to Compliance & Operational Risk Control department

Credit Suisse

Appointment of Executive Board-level Chief Compliance Office (CCO)

BARCLAYS

Global overhaul of control/ compliance structure, enhanced monitoring of electronic communication, firing of senior executives

SPEND

J.P.Morgan

Direct controls spend grew from USD 6bn (2011) to USD 9bn (2015)

HSBC

USD 3bn (+14% y/y) in regulatory programmes and compliance spend (2015), expected to peak at USD 3.3bn (2017)

Deutsche Bank

USD 1.5bn in incremental regulatory-related spending; 60% project-driven or permanent increase (2014)

Credit Suisse

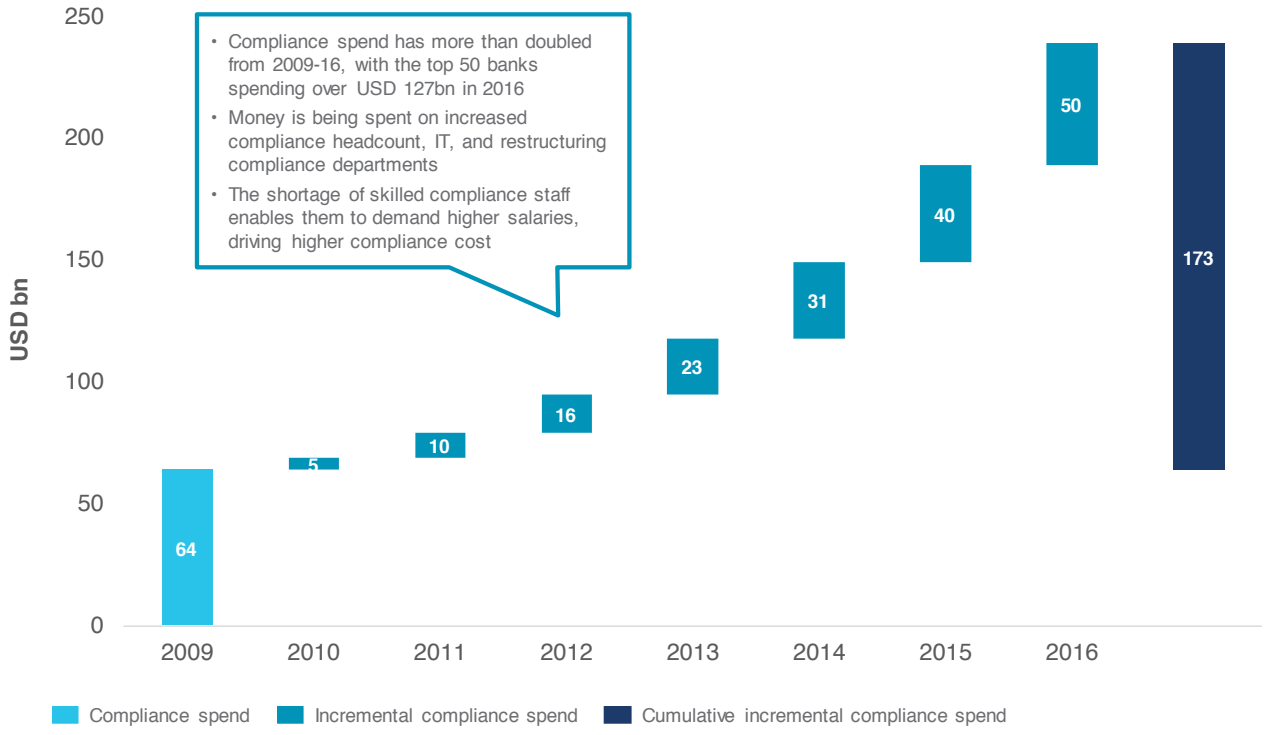
Global markets regulatory / control investment spend increased from USD 0.5bn (2012) to USD 0.9bn (2016); expected to plateau

Source: Company reports and communications, Bloomberg, Quinlan & Associates analysis

Based on extensive industry research and discussions with senior compliance professionals at leading banks, we understand the top 50 global banks spend between 10-15% of their total operating costs on compliance.[1] Accordingly, we estimate the world's 50 largest banks spent upwards of USD 127 billion on compliance and controls in 2016.

We also found, on average, that spend has roughly doubled since 2009. This implies an industry-wide incremental cumulative spend of USD 173 billion on compliance and controls from 2009-16 (see Figure 7).

FIGURE 7: COMPLIANCE SPEND OVERVIEW



Source: Press releases, Quinlan & Associates proprietary estimates

1 This includes staff costs of direct control functions, project spend, and technology investments, but ignores difficult-to-quantify indirect costs, such as the efforts of front-office employees in satisfying compliance and conduct requirements.

There currently does not appear to be a let up in compliance spending. AML/Bank Secrecy Act (BSA) regulation is becoming increasingly stringent and difficult to comply with. In 2015-16, an average of 200 international regulatory publications, challenges, and announcements that are relevant for banks, were captured daily. Banks are, however, hopeful that innovations in Fin- and RegTech will allow them to lower compliance costs in the future. In our November 2016 report, *From KYC To KYT*,[2] we estimated that blockchain technology alone has the potential to reduce AML compliance spend by USD 4.6 billion p.a. (i.e. 32% of current annual costs).

INDIRECT P&L IMPACT

5. INDIRECT COSTS

As we highlighted in our previous report on banking's talent crisis, *Don't Bank On It*,[3] the marked drop in brand rankings for many of the world's largest global banks reflects the significant impact the GFC has had on the reputations of many firms. According to a study by global brand consultancy Interbrand, of the eight banks that featured among the top 100 most valuable global brand names in 2007, only five were left by the end of 2016. More importantly, seven lost considerable ground in their global brand rankings over the period (see Figure 8).

FIGURE 8: BANK BRAND VALUES (2007 VS. 2016)

BANK	BRAND RANK (2007)	BRAND RANK (2016)	△ RANK	BRAND VALUE (2007, USD bn)	BRAND VALUE (2016, USD bn)	△ VALUE
citi	11	49	▼ 38	23.4	10.3	▼ 56%
Merrill Lynch	22	100+	▼ 78+	14.3	n.a.	n.a.
HSBC	23	47	▼ 24	13.6	10.5	▼ 23%
J.P.Morgan	32	31	▲ 1	11.4	14.2	▲ 25%
Goldman Sachs	35	54	▼ 19	10.7	9.4	▼ 12%
Morgan Stanley	37	65	▼ 28	10.3	7.2	▼ 30%
UBS	39	100+	▼ 61+	9.8	n.a.	n.a.
ING	81	100+	▼ 19+	3.9	n.a.	n.a.

Source: Interbrand Brand Value Rankings, Quinlan & Associates analysis

2 Quinlan & Associates, 'From KYC to KYC: Blockchain's Emerging Role in the Global Payments System,' November 2016, available at: http://www.quinlanandassociates.com/insights-from-kyc-to-kyt/

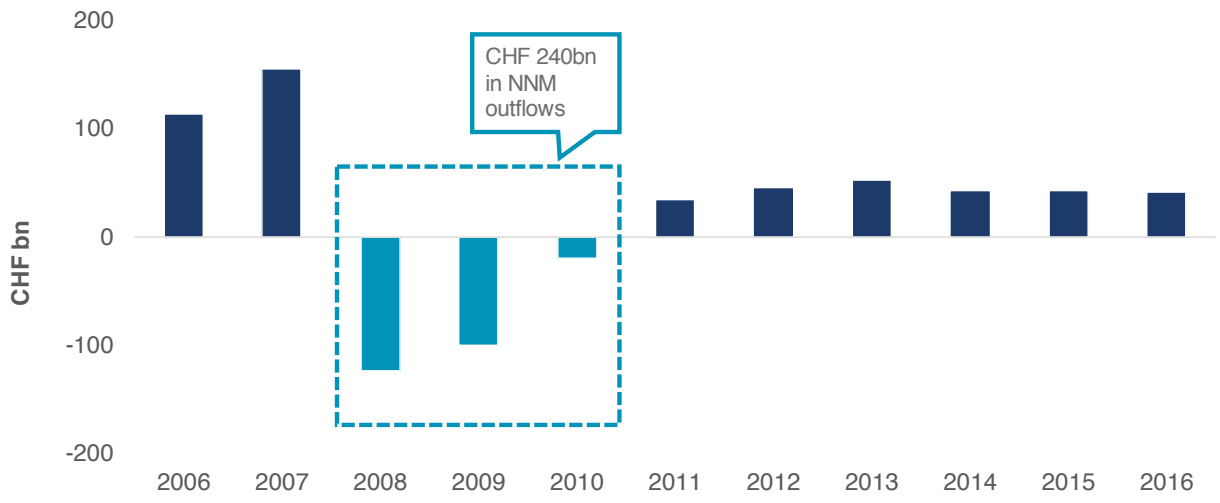
3 Quinlan & Associates, 'Don't Bank on it: An In-Depth Look at Banking's Talent Crisis,' January 2017, available at: http://www.quinlanandassociates.com/insights-dont-bank-on-it/

For many banks, the reputational fallout from the GFC translated to substantial goodwill impairments. In October 2008, for example, Wachovia reported a USD 18.7 billion goodwill impairment charge prior to its acquisition by Wells Fargo for USD 15.1 billion.[4] The following year, RBS reported an impairment loss of GBP 15 billion (USD 24.2 billion) in relation to its acquisition of Dutch bank ABN Amro.

The reputational fallout from the GFC, as well as various misconduct scandals, had a very tangible impact on a number of firms beyond write-downs to goodwill. In 2007, UBS Wealth Management's total assets under management (AUM) amounted to CHF 2.3 trillion, making it the world's largest wealth manager.

Following the bank's massive subprime write-downs in 2008, UBS struggled to maintain its reputation among wealthy clients, who remained concerned about the bank's solvency and reputation. As a result, the wealth management business saw CHF 240 billion in net new money (NNM) outflows between 2008 to 2010, which have only just been recovered in the cumulative six years since (see Figure 9). More recently, Deutsche Bank witnessed sizeable client outflows following speculation in September 2016 that it would need to pay a multi-billion dollar settlement with the DoJ for its role in the sale of MBS.

FIGURE 9: UBS WEALTH MANAGEMENT NET NEW MONEY FLOWS (2006-16)



Note: Includes net new money flows for WM International & Switzerland, WM Americas, and Swiss Business Banking

Source: Company annual reports, Quinlan & Associates analysis

4 Wachovia Corp, 'Q3 2008 Press Release,' 22 October 2008, available at: https://www.last10k.com/sec-filings/36995/0000950144-08-007959.htm

Many of the global banks also suffered credit ratings downgrades tied directly to their write-downs or major trading losses (see Figure 10). In addition to driving higher funding costs, several firms also saw large chunks of revenue dry up in certain business lines, such as prime finance and derivatives. This is because their clients could not trade with counterparties below a specific credit rating, or because the banks themselves needed to post additional collateral on certain counterparty contracts.

FIGURE 10: RATING DOWNGRADES

DATE	BANK	AGENCY	SUBSEQUENT TO	RATING CHANGE
Oct 2007	Merrill Lynch	Standard & Poor's	USD 7.9 billion write-down	▼ AA- to A+
Oct 2011	UBS	Fitch / S&P	USD 2.3 billion rogue trading loss	▼ A+ to A
May 2012	J.P.Morgan	Fitch	USD 6.2 billion rogue trading loss	▼ AA- to A+

Source: Press releases, Quinlan & Associates analysis

Our analysis does not incorporate the indirect cost imposed on the sector by higher levels of regulatory capital. According to the Bank of International Settlements (BIS), the world's 30 Globally Systemic Important Banks (G-SIBs) upped their common equity by about USD 1.3 trillion since 2009. In many tax jurisdictions, debt receives a more favourable tax treatment than equity. At the same time, the cash stuffing bank balance sheets imposes an opportunity cost and has lowered banks' overall Return on Equity.

Our analysis also doesn't take into account the substantial legal expenses banks have shelled out since 2009. For example, JPMorgan spent an estimated USD 1 billion on attorney fees in 2013,[5] while legal fees from the bankruptcy of Lehman Brothers reached an estimated USD 2.2 billion.[6]

5 CNN Money, 'JPMorgan's CEO gets 74% pay-hike despite legal woes,' 24 January 2014, available at: http://money.cnn.com/2013/09/13/news/companies/lehman-bankruptcy-fees/index.html

6 CNN Money, 'Five years on from the collapse of Lehman Brothers, fees from largest bankruptcy in US history are still adding up,' 13 September 2013, available at: http://money.cnn.com/2013/09/13/news/companies/lehman-bankruptcy-fees/index.html

TOTAL P&L IMPACT

Write-downs and trading losses in the aftermath of the GFC have represented substantial direct costs to the world's 50 largest banks. Almost 10 years after the crisis, the knock-on effects are still unravelling and related costs continue to rise for many institutions.

Overall, we estimate the top 50 global banks have taken a USD 850 billion P&L hit as a result of employee misconduct. If we also consider indirect costs including goodwill impairments, increased funding costs, legal fees, and reduced client activity from reputational damage and credit ratings downgrades, this number is likely to exceed USD 1 trillion.

OVERALL, WE ESTIMATE THE TOP 50 GLOBAL BANKS HAVE TAKEN A USD 850 BILLION P&L HIT AS A RESULT OF EMPLOYEE MISCONDUCT, IF WE ALSO CONSIDER INDIRECT COSTS, THIS NUMBER IS LIKELY TO EXCEED USD 1 TRILLION

SECTION 2
A GLIMPSE OF RECENT RISK EVENTS

INTRODUCTION

The cost of employee misconduct to the financial services industry over the past decade has been nothing short of catastrophic. And as fines continue to be levied and compliance spend rises, this number will only go one way: up.

The root cause of the GFC – and many of the industry's woes – can be traced back to the banking industry's high risk, high reward culture. Incentives that place strong focus on short-term gains, tolerance towards unethical behaviour, and a lack of personal accountability with respect to the long-term effects of that behaviour, appear to have driven excessive risk taking across the financial industry. Moreover, the previously weak regulatory landscape did little to curb these high-risk corporate cultures.

An inability for senior management to accept criticism or to listen to differing views also comes up as a common theme when analysing the banking sector. Former RBS CEO, Fred Goodwin, was identified as being obsessed with growing the bank at all costs. With 20 acquisitions in just eight years, he turned RBS into Europe's biggest bank by assets. Goodwin was stripped of his knighthood following the bank's government bailout. His predecessor, George Mathewson, later admitted that Goodwin scared people and that they had not been telling him bad news.[7] RBS reported its ninth consecutive annual loss in 2016. The 73% government-owned bank has made a cumulative loss of GBP 58 billion (USD 73 billion) since 2008.

Stan O'Neal, former CEO of Merrill Lynch, was also notoriously intolerant of dissent and refused to listen when his vision of making the bank a top underwriter of CDOs was challenged. Many executives who dared voice their opinions were subsequently fired.[8]

Dick Fuld, former CEO of Lehman Brothers, was warned by the firm's Global Chief of Fixed Income about the bank's exposure to the subprime market. He, and several other risk managers, were ignored. Former Lehman employee Andrew Growers told the media after the bank's failure: '[…] that's not to say they didn't have proper risk management processes in place: they had some very good people doing it […] but the prevailing atmosphere was for fast growth and special fast-track treatment for what we now know were toxic deals.'[9]

THE GFC

A review of government and court documents published in the wake of the GFC illustrates how banks knowingly sold dangerous and overvalued products to investors. JPMorgan CEO Jamie Dimon is reported to have instructed staff to lower the bank's exposure to the US mortgage market in 2006.

The 2011 US senate's bipartisan report[10] which analyses the financial crisis revealed that Deutsche Bank and Goldman Sachs were not only aware of the risks but also actively betted against the very products they were selling to investors. The toxic asset bubble continued to grow as traders built positions that they themselves could profit from,

7 The Guardian, 'Banking's Big Question: Why Didn't Anybody Stop Them,' 15 February 2009, available at: https://www.theguardian.com/business/2009/feb/15/banking-recession

8 Fortune, 'Crash of the titans: The rise and fall of Stan O'Neal,' 4 November 2010, available at: http://fortune.com/2010/11/04/crash-of-the-titans-the-rise-and-fall-of-stan-oneal/

9 The Guardian, 'Banking's Big Question: Why Didn't Anybody Stop Them,' 15 February 2009, available at: https://www.theguardian.com/business/2009/feb/15/banking-recession

10 United States Senate, 'Wall Street and The Financial Crisis: Anatomy of Financial Collapse,' 13 April 2011, available at: https://www.hsgac.senate.gov/imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf

with full knowledge of senior management. Emails revealed that Greg Lippmann, Head CDO trader at Deutsche Bank called the CDO market a 'ponzi scheme.' He convinced senior management to build up a USD 5 billion short position in, in his own words, 'crap' RMBS securities underlying many CDOs.

Goldman Sachs was found to operate in a similar manner. Throughout 2007, the bank sold MBS and CDO securities without disclosing the fact that it had a net short position against the subprime market. The bank's CEO, Lloyd Blankfein, admitted in a senate hearing that his bank failed to raise the alarm about excesses in the mortgage industry. The bank was fined USD 550 million for its actions, but no individual employees were held accountable.

LIBOR

The Libor scandal revealed that groups of derivatives traders at over a dozen banks regularly attempted to rig the benchmark interest rate. Barclays initially tried to portray the responsible traders, who apparently offered favours in exchange for manipulated numbers, as 'rotten apples' in an otherwise well-functioning bank. Then chief executive officer (CEO) Bob Diamond even wrote in a staff memo that 'on the majority of days, no requests were made at all [to manipulate Libor].'[11] The boldness with which Barclays traders colluded, both within Barclays and with employees from other banks, together with Bob Diamond's reaction to the affair, suggests this behaviour was widely tolerated. Traders were comfortable enough to make written requests via online chatrooms – requests that were at the very least immoral and, in most cases, illegal.

At UBS, the rigging of Libor was also discussed in emails and on internal chat forums, with the bank's compliance staff consistently failing to pick up on these communications. US prosecutors stated that the behaviour of the traders involved in manipulating Libor was 'motivated by profit while harming others.'[12] Questions were raised as to whether the industry had learnt anything from the scandal when it was revealed that several banks subsequently participated in the rigging of foreign currency exchange rates, even after being fined billions of dollars for manipulating Libor.

MONEY LAUNDERING

A review of the fines relating to AML compliance breaches revealed that prosecutors consistently found employees actively and knowingly engaged in illegal procedures. The removal of incriminating information from payment messages and the use of cover payment methods were found to be widespread. Senior management and compliance officers ignoring warnings from employees allowed this behaviour to continue for substantial periods of time. Resisting the implementation of an effective AML control framework was a common denominator in the reviewed AML cases.

Weak control systems also played a role in several rogue trading scandals. UK and Swiss regulators called UBS's control systems 'seriously defective,' stating that 'the lack of supervision from top

11 BBC World, 'Libor Scandal: Bob Diamond's letter to Barclays staff,' 2 July 2012, available at: http://www.bbc.com/news/business-18678731

12 Department of Justice, 'UBS Securities Japan Co. Ltd. To Plead Guilty to Felony Wire Fraud for Long-running Manipulation of LIBOR Benchmark Interest Rate,' 19 December 2012, available at: https://www.justice.gov/opa/pr/ubs-securities-japan-co-ltd-plead-guilty-felony-wire-fraud-long-running-manipulation-libor

managers allowed the unauthorised trading to continue for an extended period of time.'[13] Following the London Whale scandal, the Financial Conduct Authority (FCA) stated that JPMorgan's failings were 'extremely serious' and that 'losses were caused by a high risk trading strategy, weak management of that trading, and an inadequate response to important information […].'[14]

MIS-SELLING

Further investigation into the sales practices at the Community Bank of Wells Fargo revealed that employees attempting to meet demanding sales targets drove fraudulent employee practices.[15] The bank's culture and performance management system, together with aggressive sales management practices, created pressure on employees to sell unwanted or unneeded products to customers, which drove the opening of millions of unauthorised accounts.

The investigation also stated that the head of the Community Bank, Carrie Tolstedt, and her inner circle, were 'insular and defensive and did not like to be challenged or hear negative information. Even senior leaders within the Community Bank were frequently afraid of or discouraged from airing contrary views.'[16]

SUMMARY

It is clear that many of the bank scandals over the past decade were linked by common causes. While weak control systems were a contributing factor for several infamous trading scandals, the vast majority of issues stemmed from what can only be described as bad behaviour.

Excessive risk-taking, questionable sales methods, market manipulation, and outright fraudulent practices became all-too-common in an industry where employees were incentivised by bonuses that were linked to top-line P&L. And the widespread tolerance by senior management towards many of these practices points to a problem that is much more significant than a few "bad eggs": it reflects a fundamental weakness in risk culture across the industry.

13 BBC World, 'UBS fined GDP 29.7m by FSA over Kweku Adoboli case,' 26 November 2012, available at: http://www.bbc.com/news/business-20492017

14 Financial Conduct Authority, 'JPMorgan Chase Bank N.A. fined GDP 133,610,00 for serious failings relating to its Chief Investment Office's "London Whale" trades,' 19 September 2013, available at: https://www.fca.org.uk/news/press-releases/jpmorgan-chase-bank-na-fined-£137610000-serious-failings-relating-its-chief

15 Wells Fargo, 'Sales Practices Investigation Report,' 10 April 2017, available at: https://www.wellsfargo.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf

16 Independent Directors of the Board of Wells Fargo and Company, 'Sales Practices Investigation Report,' 10 April 2017, available at: https://www.wellsfargo.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf

SECTION 3
DEVELOPMENTS IN RISK MANAGEMENT

THE CONCEPT OF RISK

'In order to prevent future crises, we need to do more than tighten up rules and legislation.'

– De Nederlandsche Bank (Dutch Central Bank)[17]

The international regulatory framework has been significantly strengthened since the GFC, with efforts being made to increase the resilience of the financial system as a whole and to lower systemic risk. Basel III stressed the need for more stringent liquidity and solvency requirements, particularly for banks designated as so-called G-SIBs. Ultimately, the measures were designed to reduce market risk. The Basel Committee has announced that the standardised approach for credit risk should be adjusted to increase its sensitivity. Operational risk breaches relating to AML have also initiated a wave of new regulation, which includes more stringent evaluation of customers (i.e. Know Your Customer (KYC) and Customer Due Diligence (CDD)).

CULTURE AS A RISK FACTOR

Although authorities in both the US and Europe have been quick to implement new legislation post-2009, a more recent development in the financial sector's regulatory landscape is a focus on culture as a possible risk factor. The string of fines related to bank's harmful conduct advocate the need to focus on avoiding the same behaviour in the future. Harmful conduct consists of all conduct that is not necessarily illegal but that could harm the interest of investors, jeopardise transparent, fair, and efficient markets, and/or lead to potential systemic risk.

The risk associated with this bad conduct has been coined "conduct risk" (the terms "behavioural risk" and "cultural risk" have also been cited). The key question is: How should banks manage this unquantifiable risk?

FORMAL RISK MANAGEMENT MODEL: THREE LINES OF DEFENCE

The 'Three Lines of Defence' model is used to manage risk in companies across a wide range of industries, and attention has been paid to its application in the banking industry by, for example, the Basel Committee and the European Banking Authority (EBA).[18]

The first line of defence (1LOD) consists of the business units (front office/customer-facing), in which front-line employees are responsible for identifying, assessing, and controlling the risks of their business. The second line of defence (2LOD) includes the chief risk office (CRO) and the compliance function. It is here that risk management is overseen and challenged. Compliance provides guidance for the different business units and develops the bank's risk management framework. The third line of defence (3LOD) is the bank's internal audit function, which reviews the first and second lines. This internal audit team is intended to be objective as it provides an independent perspective and challenges the processes of the other two lines (see Figure 11).[19]

It has been proposed that adding a so-called fourth line of defence, external audit, and fifth line of defence, the regulator, complements this risk management model.

17 De Nederlandsche Bank, 'Behaviour and Culture in the Dutch Financial Sector,' June 2016, available at: https://www.dnb.nl/en/binaries/DNB%20brochure%20gedrag%20en%20cultuur%202015%20ENG_tcm47-326577.pdf?2016063018

18 Basel Committee on Banking Supervision, 'Guidelines: Sound management of risk relating to money laundering and financing of terrorism,' February 2016, available at: www.bis.org/bcbs/publ/d353.pdf

19 Institute of Risk Management, see: https://www.theirm.org/about/published-articles/drawing-a-line-under-the-3-lines-of-defence-in-banking.aspx

FIGURE 11: THREE LINES OF DEFENCE RISK MANAGEMENT MODEL

1	2	3
1st LINE OF DEFENCE	**2nd LINE OF DEFENCE**	**3rd LINE OF DEFENCE**
Business Units	**Risk & Compliance**	**Internal Audit**
Identify, assess, and control the risks of doing business	Provide guidance for business units and develop internal risk management framework	Independent review ofthe first and second lines of defence

Source: Institute of Risk Management, Quinlan & Associates analysis

THE MISMATCH

'So the danger lies predominantly with the 1LOD; those who should be responsible for managing risk but have confused their responsibilities by references to the 3LOD' - *Institute of Risk Management*[20]

Changes made by banks to better manage risk since the GFC have largely been reactionary in nature and have been directed primarily at the second and third lines of defence.

Of particular note, banks have hired more compliance staff, made additional investments in surveillance software, and expanded the authority of the CRO and their compliance function. The 3LOD has been enhanced by introducing topical audits (i.e. cyber security audits) and audits more specifically catered to certain regions (see Figure 12).

20 Institute of Risk Management, 'Drawing a line under the 3 Lines of Defence in Banking,' 4 July 2014, available at: https://www.theirm.org/about/published-articles/drawing-a-line-under-the-3-lines-of-defence-in-banking.aspx

FIGURE 12: BANK ACTIONS IN THE THREE LINES OF DEFENCE MODEL

1

1st LINE OF DEFENCE

Business Units

- Rollout of mandatory compliance training across-the-board
- Adaptations to bonus schemes, including instituting deferral periods and bonus claw-backs
- Introduction of penalties for front-line compliance breaches (e.g. "red flags")

2

2nd LINE OF DEFENCE

Risk & Compliance

- Hiring of additional compliance staff
- Expansion of CRO authority
- Simplification of governance structure and reporting lines
- Alignment of compliance & risk management function
- Investment in AML and KYC controls
- Intensifying monitoring of internal communications and chatroom controls

3

3rd LINE OF DEFENCE

Internal Audit

- Bolstering of internal audit capabilities, including increases in headcount
- Regularly rotating internal audit teams
- Introduction of deep-dive topical and regional audits, focusing on jurisdictional or subject 'hot spots'

Source: Press releases, Quinlan & Associates analysis

Despite the significant strides that have been made by banks with respect to their 2LOD and 3LOD, we feel that many of these investments have been made at the expense of the 1LOD; the epicentre of an organisation's cultural identity. And, as discussed in Section 2, the vast majority of fines levied on financial institutions since the GFC are not related to a failing of compliance or audit departments; they are, put simply, a direct result of bad behaviour.

Even for those banks which have made considerable progress in bolstering their 1LOD, efforts have largely been limited to rolling out mandatory compliance training and making adaptations to bonus schemes, including the introduction of deferral periods and clawbacks. While progress has also been made around the redesign of employee incentives and risk communication strategies, we feel a meaningful change in the mindset of many employees has yet to occur. Case in point is the recent revelation that

the Commonwealth Bank of Australia is being accused of serious AML breaches. In August 2017, the Australian Prudential Regulation Authority (APRA) announced its intention to roll out a full-scale inquiry into the governance, culture, and accountability frameworks and practices at the bank.[21]

The near-decade since the GFC revealed that the people who should have been responsible for recognising and managing risk (i.e. the business units) regularly waived their responsibilities by making references to the other lines of defence.

We believe greater attention must be paid to strengthening the 1LOD, especially a bank's overall risk culture, to better address problems at their source. Only then can risk-taking be effectively controlled and a risk culture that is built on principles of ownership and accountability be achieved.

THE NEAR-DECADE SINCE THE GFC REVEALED THAT THE PEOPLE WHO SHOULD HAVE BEEN RESPONSIBLE FOR RECOGNISING AND MANAGING RISK REGULARLY WAIVED THEIR RESPONSIBILITIES BY MAKING REFERENCES TO THE OTHER LINES OF DEFENCE.

21 Australian Prudential Regulation Authority, 'APRA to establish independent prudential inquiry into governance, culture, and accountability within CBA,' 28 August 2017, available at: http://apra.gov.au/MediaReleases/Pages/17_34.aspx

Q&A SAY...

GERMAN ROAD SAFETY

We believe the ultimate end-goal for banks is one in which all employees have voluntarily internalised the responsibilities that comes with their roles, including any and all risks the role encompasses. It is here we believe an interesting parallel can be drawn to the licensing regime and road safety situation in Germany.

To obtain a driving license in Germany, would-be drivers must undergo a rigorous testing process, including passing a theoretical and practical examination. The theoretical exam consists of 30 multiple choice, multiple answer questions, with negative markings for nulled or incorrect responses. A score of 100 out of 110 is required to pass.[22]

Applicants are also put through a 45-minute driving test (including driving at high speeds) with an instructor and an inspector/examiner, with any small mistakes resulting in instant failure. As a result, nearly a third of all Germans fail their first driving test.[23] The development of sound driving skills and ingraining a sense of responsibility to oneself and others, can in many respects be likened to a bank's 1LOD. In the case of Germany, it appears to be a cultural norm for drivers to take full ownership of their obligations on the road, especially road safety.

Road traffic laws (i.e. the 2LOD) in Germany, however, are in many cases relatively lax, especially on large parts of the German autobahn where there are no speed limits. Germany is, in fact, the only developed country in the world that does not impose such limits. Although speed is often cited as one of the main causes of road fatalities, Germany has one of the lowest traffic-related death rates in the world. According to World Life Expectancy, Germany's road traffic death rate per 100,000 inhabitants is 3.94 per year. This is lower than in France which, despite a crackdown on speeding, has a corresponding death rate of 5.65. In the US, where the requirements for obtaining a driving licence are much more lenient than in Germany and speed limits are strictly enforced, the death rate stands at 9.99.[24]

Of particular note is the fact that the German police force (i.e. the 3LOD) is of a similar size as those in countries such as the US, and in line with the global median on a per capita basis (i.e. ~300 police officers per 100,000 inhabitants),[25] while its penalties for traffic offences (i.e. the 4LOD) are no more punitive than those of other leading developed nations.

The above example demonstrates that if there is a cultural norm that makes people aware of their responsibilities and the possible dangerous consequences of their behaviour, this will do more to curb risk-taking activity than excessive rules and regulations, including the threat of severe penalties. We believe the development of a sound risk culture around driver awareness and road safety among Germany's driving community sits behind the country's impressive road fatality statistics. We believe this evolution in thought is exactly what the banking industry needs.

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22 Quora, 'Why is it so difficult to get a German driving license?', August 2017, available at: https://www.quora.com/Why-is-it-so-difficult-to-get-a-German-driving-license

23 The Local, 'Nearly a third of Germans fail their driving test,' 22 January 2013, available at: https://www.thelocal.de/20130122/47483

24 World Life Expectancy. See: http://www.worldlifeexpectancy.com/cause-of-death/road-traffic-accidents/by-country/

25 World Heritage Encyclopedia Edition, 'List of Countries By Number Of Police Officers

SECTION 4
CORPORATE CULTURE, RISK CULTURE, AND CONDUCT RISK

'Ultimately, a sound risk culture across the industry is not something that can be regulated into existence. It requires persistence by those tasked with the stewardship of financial institutions.' – *Australian Prudential Regulation Authority*[26]

Commonly cited definitions of corporate culture are: 'a complex set of symbols, values, beliefs, and philosophies that characterise the way in which a firm conducts its business,'[27] and '...a system of shared values that define what is important, and norms that define appropriate attitudes and behaviours for organisational members.'[28] Corporate cultures evolve over time and are subject to the influence of internal and external forces. Moreover, several sub-cultures may exist within one organisation.

Risk culture can be thought of as the impact that corporate culture has on risk management. This includes the influence that corporate culture has on risk governance: how risks are managed, and risk appetite (i.e. the risk profile that a company is comfortable with). Approaches to manage risk culture are in the relatively early stages of development. Authorities in the US, the UK, Singapore, and the Netherlands are leading the way by developing specific risk culture regulatory expectations. The Central Bank of the Netherlands (DNB), states that: 'supervision of behaviour and culture has proved a valuable supplement to the more traditional forms of financial supervision.'[29]

The Hong Kong Monetary Authority (HKMA) has also published an elaborate policy manual in which it explains its risk-based supervisory approach, outlines elements of a robust risk management framework, and provides guidelines on sound remuneration policies.[30] In addition to this, the HKMA published a circular dedicated to bank cultural reform in March 2017, which provides additional practical guidance for financial institutions to develop sound risk cultures, including the establishment of board-level committees.[31]

Although we think this is a step in the right direction, cultures cannot be regulated into existence: a bank's cultural identify must be created from within and reflect its individual DNA, and we believe it is here that many organisations still have much to do. As a first step, effectively managing risk-taking will only be possible when the concepts of risk culture and conduct risk have been accurately defined. And the majority of banks have failed to adequately do this. In fact, a 2016 survey by Thomson Reuters found that 64% of financial institutions currently have no working definition of conduct risk.[32]

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26 Australian Prudential Regulation Authority, 'Information Paper: Risk Culture,' October 2016, available at: http://www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf

27 Sorensen, J.B. 2002, 'The Strength of Corporate Culture and the Reliability of Firm Performance.' Administrative Science Quarterly Vol 47: pp 70-91

28 O'Reilly, C.A. and J.A. Chatman. 1996, 'Culture as Social Control: Corporations, Culture and Commitment.' Research in Organizational Behavior Vol 18: pp 157-200

29 De Nederlandsche Bank, 'Behaviour and Culture in the Dutch Financial Sector,' June 2016, available at: https://www.dnb.nl/en/binaries/DNB%20brochure%20gedrag%20en%20cultuur%202015%20ENG_tcm47-326577.pdf?2016063018

30 Hong Kong Monetary Authority, 'Supervisory Policy Manual,' 2017, available at: http://www.hkma.gov.hk/eng/key-functions/banking-stability/supervisory-policy-manual.shtml

31 Hong Kong Monetary Authority, 'Bank Culture Reform,' 2 March 2017, available at: http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170302e2.pdf

32 Thomson Reuters, 'Cost of Compliance 2016,' June 2016, available at: https://risk.thomsonreuters.com/en/resources/special-report/cost-compliance-2016.html

CULTURAL DRIVERS

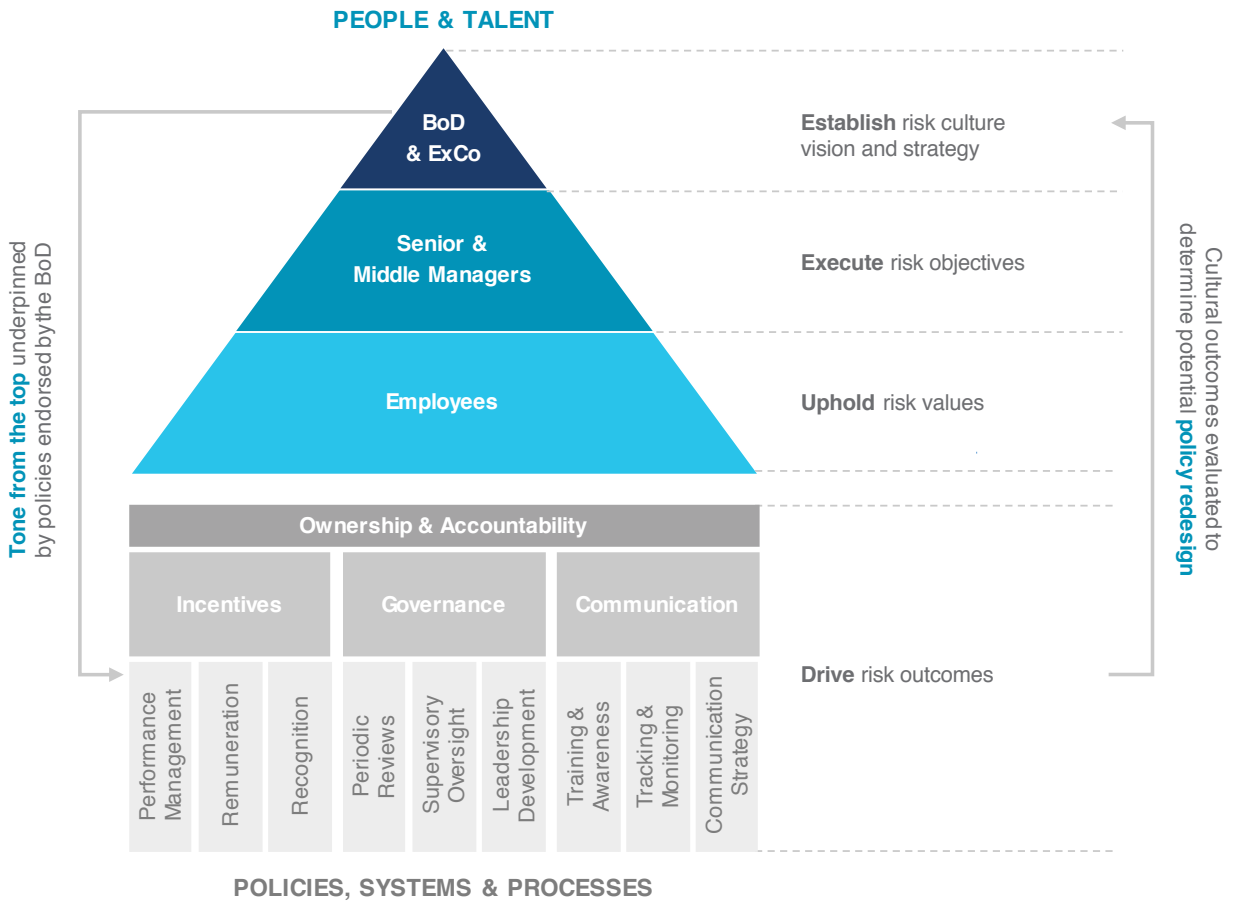
The tone set from the top of an organisation provides the cultural tone for the company as a whole. This cultural "tone from the top" must be endorsed by the Board of Directors (BoD) (especially the firm's CEO), cascaded throughout the ranks, and underpinned by organisational policies, systems, and processes. And these policies must, at their core, enforce employee accountability. To achieve this, a holistic assessment of an organisation's culture evolution pyramid must be conducted (see Figure 13).

Policies that do not align with the tone from the top, discrepancies between what senior managers are communicating to their staff and what they themselves are doing, incentives that drive excessive risk-taking, and overly complex governance structures, all breed a culture in which risk is poorly controlled.

While progress around risk policies and frameworks has no doubt been made by a number of firms, we believe the industry is still struggling to create a risk mindset that not only promotes a climate of individual accountability, but one of true ownership.

THE TONE SET FROM THE TOP OF AN ORGANISATION PROVIDES THE CULTURAL TONE FOR THE COMPANY AS A WHOLE. THIS CULTURAL "TONE FROM THE TOP" MUST BE ENDORSED BY THE BOARD OF DIRECTORS (BOD) (ESPECIALLY THE FIRM'S CEO)

FIGURE 13: CULTURE EVOLUTION PYRAMID



Source: Quinlan & Associates proprietary framework

PEOPLE & TALENT

TONE FROM THE TOP…AND MIDDLE

The BoD and Executive Committee play a vital role in determining a bank's attitude towards risk. Due to their high visibility, their actions showcase the kind of behaviour that is accepted and appreciated within an organisation. However, research by DNB found that executive directors frequently fail to sufficiently abide by the values that they have endorsed, while bank employees say their CEOs regularly fail to 'walk the talk' and that instances of 'do as I say, not as I do' are widespread.[33]

Senior management should not only set the right example; they hold the responsibility to outline a clear risk appetite statement. Consistently defining risk management terms and enhancing a common understanding of these terms across the organisation is a vital step in creating a culture of risk awareness.[34] This step has not yet been taken by many banks.

Bob Diamond, the former CEO of Barclays, downplaying the severity of the Libor manipulation practices at the bank, fuelled the public perception that the illegal behaviour of traders was an accepted way of doing business within Barclays' cultural framework. JPMorgan's CEO, Jamie Dimon, was given a 74% pay rise by the BoD in 2014, bringing his salary to USD 20 million. The BoD stated it had considered 'several key factors,' including the bank's sustained long-term performance.[35] Although JPMorgan reported a USD 17.9 billion profit in 2013, the bank also paid billions of dollars in fines, with Dimon negotiating an out-of-court settlement with the DoJ over the bank's sale of bad mortgage investments. Concerns were raised following the pay rise, with some saying it sent the wrong message and could trigger a backlash from regulators.

By contrast, Oswald Grübel, former CEO of UBS, sent out a markedly different message following the bank's 2011 rogue trading scandal. In a move that was welcomed by the Swiss Parliament, Grübel stepped down from his role, writing in a staff memo: 'I am convinced that it is in the best interest of UBS to approach the future with a new leader.'[36] UBS's chairman stated that 'Oswald Grübel feels that it is his duty to assume responsibility for the recent unauthorised trading incident. It is testimony to his uncompromising principles and integrity.'[37] This best practice example feeds into accountability (see Section 4.2); by taking responsibility for the scandal, Grübel set a precedent for employees at all levels of UBS.

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33 De Nederlandsche Bank, 'Behaviour and Culture in the Dutch Financial Sector,' June 2016, available at: https://www.dnb.nl/en/binaries/DNB%20brochure%20gedrag%20en%20cultuur%202015%20ENG_tcm47-326577.pdf?2016063018

34 International Finance Corporation, World Bank Group, 'Risk Culture, Risk Governance, and Balanced Incentives,' August 2015, available at: https://www.ifc.org/wps/wcm/connect/4e887b2e-5999-485e-95b1-428c157cfea6/IFC+Risk+Culture+Governance+Incentives+report.pdf?MOD=AJPERES

35 CNN Money, 'JPMorgan Chase boss Jamie Dimon got a 74% pay hike for last year, even though the bank was forced to pay billion in fines and settlements last year,' 24 January 2014, available at: http://money.cnn.com/2014/01/24/news/companies/dimon-pay/index.html

36 New York Times, 'Rogue Trading Leads UBS Chief to Resign,' 24 September 2011, available at http://www.tedbaker.com/nl/Womens/Clothing/Dresses/WINNI-Front-fold-pleated-dress-Brick-Red/p/137626-BRICK-RED

37 ABC News, 'UBS CEO Oswald Grübel Resigns Over USD2.3 Billion Rogue Trading Loss,' 24 September 2011, available at: http://www.tedbaker.com/nl/Womens/Clothing/Dresses/WINNI-Front-fold-pleated-dress-Brick-Red/p/137626-BRICK-RED

When misconduct does occur, the BoD and Executive Committee must consider whether similar misconduct could arise in other parts of the bank. Furthermore, determining whether the incident is the responsibility of an isolated employee or if there is another root cause of the bad behaviour is essential.[38] For example, Wells Fargo fired 5,300 employees following their "fake accounts" scandal (see Section 2). In doing so, however, the bank failed to recognise the systematic nature of the problem, as well as acknowledge the contributing effect of the bank's culture in driving employee misconduct.

It is vital that senior management across the bank recognises that changing risk culture and nurturing accountability are no longer secondary tasks that can be left solely to risk management departments or the BoD – they are a must-do to ensure the future stability of any organisation, and deserve the full attention of all employees, especially those holding positions of managerial responsibility. While we feel senior management must dedicate more time to engaging with employees throughout the organisation to effect cultural change, the role middle management can (and should) play in cascading that down through the ranks has still not been adequately addressed. "Tone from the top" needs to translate into an effective "tone from the middle." And it is middle managers that must act as the bank's risk culture carriers and actively seek to generate buy-in amongst their peers and subordinates.

POLICIES, SYSTEMS & PROCESSES

ACCOUNTABILITY

The wave of taxpayer bailouts at the height of the GFC was met with outrage by the general public, reflecting a widespread feeling that many bankers had not been held responsible for what was perceived as self-enriching behaviour at the expense of the average citizen. Following extensive criticism for penalising banks rather than individual employees, regulators have been focusing more of their attention on enforcing personal liability, with a particular emphasis on supervisory oversight, including Global Supervisory Attestation. For example, in 2016, the FCA and Prudential Regulation Authorities (PRA) introduced the Senior Managers Regime (SMR) in the UK. The SMR mainly refines and formalises regulatory expectations on accountability and expects individuals to demonstrate that they are taking reasonable steps to do the right thing.[39] The Manager-In-Charge regime, which was introduced by the Securities and Futures Commission (SFC) of Hong Kong in December 2016, is a similar initiative.

Moreover, since 2015, several criminal charges have been brought against individual traders and brokers for their role in manipulating key interest rates by both US and UK authorities. The success of these prosecutions has, however, varied greatly.

Although regulators are now seeking to hold more individuals accountable for their past behaviour, there are still few signs of labour market discipline. Research shows that in 2016, 85% of residential MBS bankers remained in the industry and there

38 Monetary Authority of Singapore, 'Culture and Conduct – A Regulatory Perspective,' 6 March 2017, available at: http://www.mas.gov.sg/News-and-Publications/Speeches-and-Monetary-Policy-Statements/Speeches/2017/Culture-and-Conduct.aspx

39 Financial Conduct Authority, 'Senior Managers Regime,' 7 March 2016, available at: https://www.fca.org.uk/publication/corporate/applying-smr-to-fca.pdf

is no evidence that indicates they suffered from fewer promotions or worse job opportunities at other banks.[40]

We believe accountability lies at the heart of an effective risk culture. Per our culture evolution pyramid, key to developing an appropriate accountability framework are the following three factors: (1) incentives; (2) governance; and (3) communication.

1. INCENTIVES

Current Landscape

With rising levels of discontent among shareholders and the public at large, banking compensation practices have come under considerable regulatory scrutiny. Bonus caps, deferral periods, and clawback provisions have been put in place across the industry. In the UK, top bank executives now have to wait 10 years to be sure their bonus will not be clawed back. Traders and other 'risk-takers' have to wait at least three years from the time of an award to receive any pay-out.[41]

The Capital Requirements Directive IV (CRD IV), which became effective on 1 January 2014 in the EU, caps individual employee bonuses of EU-based credit institutions and investment arms at 100% of base salary. In response to tougher regulation, most global banks have moved to hike employee base salaries. The Bank of England (BoE) reported in 2015 that 50% of bankers' total compensation was fixed, up from 10% in 2010.[42] In addition, EU bonus caps have been sidestepped by supplementing senior banker base salary with sizeable role-based allowances. This development has imposed a new risk on many banks, as higher fixed costs lower their capability to slash expenses when faced with low profitability or economic downturns.

A number of banks have also instituted "red flag" systems for compliance breaches, with broad application to a number of areas, including AML, fraud, non-completion of compliance training, failure of attestation, and the leakage of confidential information, among various other things. Employees with a certain number of red flags against their names may have their variable compensation reduced and can also be subjected to further disciplinary action.

Future Considerations

Make risk culture a tangible KPI: We acknowledge the changes that have been made to remuneration structures, but also believe that these changes do not adequately compel the necessary shift in risk attitude. While bonuses across the industry are substantially lower than pre-GFC, they are still primarily calculated using P&L measures. We believe banks must think carefully about designing incentive structures that enforce risk awareness. While we understand progress has been made with respect to tailoring employee KPIs, particularly around variable compensation decisions, we feel "risk mind-set" (which can form part of evaluating an employee's values and beliefs) still carries very little (and quantifiable) weight in driving discretionary bonus allocations and promotion decisions. One chief operating officer (COO) we spoke to at a global private bank said most front-office employees were

40 Griffin, J.M and Kruger, S.A. and Maturana, G. 2017, 'Do Labor Markets Discipline? Evidence from RMBS Bankers,' available at: https://ssrn.com/abstract=2977741

41 Wall Street Journal, 'U.K. Bankers to Wait Seven Years for Bonuses,' 23 June 2015, available at: https://www.wsj.com/articles/u-k-bankers-to-wait-seven-years-for-bonuses-1435058850

42 The Telegraph, Bankers' bonus caps drive up salaries, says Bank of England,' 15 December 2015, available at: http://www.telegraph.co.uk/finance/bank-of-england/12052055/Bankers-bonus-cap-drives-up-salaries-says-Bank-of-England.html

still motivated by their top-line performance and, as long as they didn't explicitly breach their compliance obligations, they felt risk considerations were the domain of 'someone else' (i.e. compliance). This is an attitude that needs to change and can be achieved with effectively designed KPIs.

Set clearer internal guidelines: It is becoming increasingly evident that accountability has not translated into a real sense of ownership for many banking employees, with value-based behaviour taking a backseat to simply "ticking the boxes" and "abiding by the rules". However, even some rules remain highly subjective. A number of compliance professionals we spoke to said there were no real guidelines around employee disciplinary action, termination clauses, and reprimands, with most decisions being made on a case-by-case basis. Accordingly, we believe there is considerable scope for some banks to establish much clearer internal guidelines around how to appropriately deal with employee misconduct.

Encourage, don't just penalise: Rather than simply "red flagging" all employees for compliance breaches, such as those who fail to perform their compliance training within a designated timeframe, banks can look to reward employees who are seen by their peers as "risk champions", such as those who promote a sound risk culture within their team. It is not just monetary incentives that should be linked to risk attitude; it should also be considered as a key eligibility criterion for promotion, especially for senior management roles.

2. GOVERNANCE

Current Landscape

The sheer size and global scale of many banks makes them inherently complex. This complexity hinders effective management and can cause coordination problems both within and across divisions. Corporate governance failings have been identified as a major contributor to the GFC. The Walker Review,[43] for example, recommended that non-executive directors should spend 50% more time performing their task, that regular training sessions enabling these directors to better analyse risk and question strategic decisions should be introduced, and that all aspects of group risk should, in future, be monitored by a separate Risk Committee.

Governance structures at many global banks have indeed been altered since the crisis. Bank of America and UBS have both stripped their risk functions out of Legal and Compliance to create separate risk departments led by CROs with expanded mandates. Of note, Barclays became the first and only bank to receive credit for its governance overhaul from the DoJ after the bank initiated a global governance review. This led to significant changes in the way that control and management was structured, including expanding the monitoring of electronic communications, issuing new controls on chat rooms, and adaptations to employee reporting lines.

The majority of global banks now hold regular management meetings with a heavy emphasis on risk at the department level, as well as broader in-country, regional, and global operational committee meetings. Most banks also hold regulator meetings with in-country and offshore regulators.

43 Walker Review, 'A review of corporate governance in UK banks and other financial entities: Final Recommendations,' 26 November 2009, available at: http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf

Future Considerations

Ensure continuous leadership capability training: In 2015, Barclays agreed to plead guilty to its role in the rigging of FX rates and went on to fire several of its senior executives. The bank replaced them with a team that, from the beginning, continuously stressed the importance of compliance. While we recognise on-boarding external talent is an effective catalyst for internal change, simply replacing high-ranking employees is not enough. Banks need to ensure that future leaders are nurtured from within and understand that cultural best practice is not something that can simply be imported when things turn sour.

Calibrate reporting lines: We stress the need for clear and simple reporting lines to ensure that essential information regarding risk exposure moves easily across the organisation. More often than not, we have met bank employees with double and triple reporting lines, which we believe has the potential to blur accountability. In particular, for many smaller, regional banks, we also believe more work needs to be done to ensure department heads regularly come together so that all relevant parties understand the bank's overall risk profile. These business heads must also be empowered to make (and veto) decisions they believe will lead to excessively risky strategies.

Review hiring policies: The type of employees that banks hire is also worth reviewing, which may ultimately warrant a shift in recruitment practices. In addition to testing intelligence and analytical capabilities, a candidate's perception to risk (and risk-taking behaviour), as well as what intrinsically motivates them in their job, should be scrutinised. This will allow banks to screen out individuals who may be more prone to taking overly risky bets – and who may be more likely to succumb to ethically questionable behaviour – before they even enter the door.

3. COMMUNICATION

Current Landscape

Open communication and the ability to challenge the behaviour and actions of others is a vital element of a sound risk culture. To this end, many leading firms have supercharged their communication efforts around risk, including regular risk emails sent from the CEO and CRO, as well as the publication of periodic compliance newsletters.

Training and education form a core part of the communication process, with banks making significant efforts to make front-office employees more aware of their potentially risky behaviour. Of greatest note, mandatory compliance training has now been rolled out across the industry for all employees, irrespective of department or role. Much of this is being delivered through e-learning modules, which must be completed within specified timeframes. JPMorgan's CEO, Jamie Dimon, said that employees in the bank's mortgage business alone performed over 850,000 hours of compliance training in 2014.[44]

Efforts to encourage staff to speak up about wrongful behaviour have been formalised using industry-wide standards for whistleblowing at large financial institutions. For example, the FCA introduced new rules on whistleblowing in 2015, stating: 'These rules aim to encourage a culture in which individuals raise concerns and challenge poor practice and

44 Bloomberg, 'The Rise of the Compliance Guru,' 25 June 2015, available at: https://www.bloomberg.com/news/features/2015-06-25/compliance-is-now-calling-the-shots-and-bankers-are-bristling

behaviour.'[45] The standards include a clause that mandates banks to appoint a senior person to take responsibility for the effectiveness of their internal whistleblowing initiatives (i.e. "whistleblowing champions"). Bank-specific whistleblowing initiatives are communicated to staff during their mandatory compliance training sessions.

Many banks have also rolled out KPI dashboards/ trackers, which are designed to provide management with regular reports on the organisation's risk climate. Some of the metrics being examined include complaint cases, violation of bank policies, monitoring of employee red flags, and general regulatory breaches.

Future Considerations

Revamp training efforts: While banks have made wide-ranging efforts around employee training and education, we believe the current e-delivery method, while convenient, is not conducive to skills development. It is also common for staff to "skip" through online courses with little attention due to a lack of engagement, direct supervision, or consequences from failing quizzes. Consequently, the provision of training isn't efficiently translating into learned knowledge. Compliance training initiatives also need to be more effectively targeted; too many employees feel they are wasting time completing compliance training that is not applicable to their line of work. As a result, a considerable number of training initiatives have not resulted in a true change in employee risk mindset – if anything, they have made many in the industry more cynical.

Create a safe space to challenge: The recent whistle-blower incident involving Barclays' CEO, Jes Staley, proves that in spite of the introduction of well-defined whistleblowing initiatives, it is still difficult for employees to address wrongful behaviour, even anonymously. Both Barclays and Staley are currently being investigated by the UK's FCA and PRA following the revelation that the CEO tried to identify an internal whistle-blower. Staley has apologised publicly for his behaviour. The BoD accepted his apology but announced that 'a very significant compensation adjustment' to his bonus would be made.[46] On the flipside, however, banks need to have effective whistle-blower protocols in place to ensure such mechanisms are not being abused.

Drive collaboration between the business and compliance: We believe communication between the front office and compliance is often insufficient. When it does take place, an attitude of "us versus them", rather than one of collaboration, is prevalent. One industry insider told us: 'I see myself as the person trying to get the job done. I see compliance as the people who are trying to stop me from doing that.' The lack of communication between control functions and the front office is a major shortcoming across much of the industry. We believe co-creating risk-management frameworks will be more effective than risk-management functions autonomously pushing though increasingly demanding procedures and reporting standards.

45 Financial Conduct Authority, 'FCA introduces new rules on whistleblowing,' 6 October 2015, available at: https://www.fca.org.uk/publications/policy-statements/ps15-24-whistleblowing-deposit-takers-pra-designated-investment-firms

46 New York Times, 'Barclays CEO Apologizes for Handling of Whistle-Blower Complaint,' 10 May 2017, available at: https://www.nytimes.com/2017/05/10/business/dealbook/barclays-james-staley-whistle-blower.html?mcubz=0

Further automate risk reporting: Risk reporting, including trackers/dashboards around individual performance measurement, are often highly manual in nature, which makes them both labour-intensive and prone to errors. The sharing of these trackers with management teams, compliance, HR departments, and regulators, is also done in a rather haphazard fashion at many firms. We believe banks need to invest more in RegTech to further automate the risk reporting and distribution process as a means to improve accuracy and reduce compliance overheads. Technology can also be used to make traders aware of potential bad behaviour before it's too late, such as sharing confidential information or trading shares on restricted lists.

Refine internal communication mechanisms: While regular communication emails, including risk newsletters, are now being sent out by global and regional management, we found they are frequently ignored by bank employees. The most common complaint is that communiques are far too wordy and contain few real-life examples (i.e. case studies). While we understand some information is indeed sensitive and not for general sharing, we feel a much more simplified and relatable communication strategy is needed if messaging is to truly stick with employees.

CONCLUSION

During our discussions with industry insiders about unethical behaviour in the financial industry in the run up to the GFC, one trader stated: 'I never did anything illegal. It might be illegal now but back then it wasn't, and everybody was doing it. The regulators were sleeping. They knew exactly what we were doing and they did nothing.'

While attitudes towards risk-taking may not be as brazen in today's climate, we believe there is still a lack of personal accountability (and a real sense of ownership) across the industry. And, as outlined in Section 1, this lack of accountability has likely destroyed at least USD 850 billion in industry profits in the near-decade since the GFC.

Although banks have undertaken a raft of measures to better manage their risks, the majority of these efforts have focused on the 2LOD and 3LOD, which are simply not enough to drive cultural change. In reality, many of the risk measures implemented by banks to-date are remedial and rules-based, and seek to drive behavioural change through a fear of being caught, rather than engendering a more fundamental evolution in risk culture where employees do the right thing simply because it is the right thing to do.

We see the most effective risk culture framework as one in which problems are addressed at their source; the first line of defence. Although regulators such as the HKMA and the FCA acknowledge that there is no one-size-fits-all approach to risk management, there is consensus amongst regulators and advisory committees worldwide that creating a sense of accountability can and will only be achieved when particular attention is paid to incentives, governance, and communication. Moreover, an effective tone from the top is vital for a bank to maintain a healthy risk appetite, and the BoD message should be delivered and understood across the organisation, with middle-management needing to play an active role.

We believe banks must adopt a more holistic approach for developing a sound risk culture. Forward-looking measures focused on both encouraging and recognising good behaviour and sound risk values need to replace many of the retroactive, penalty-based risk-mitigation policies that are in place today. We feel there is simply too much value at risk for such an approach to be ignored.

SECTION 5
HOW CAN WE HELP?

Our consultants have worked with a number of regional and global banks on enhancing their risk cultures. Underpinned by our culture evolution pyramid and the need to drive an effective "tone from the top" (and middle) and individual accountability, some of the work we do includes:

INCENTIVES

- Developing practical and quantifiable KPIs linking risk culture and employee behaviour to variable compensation and promotion outcomes
- Creating clear internal guidelines around employee disciplinary action, particularly in relation to individual misconduct
- Formulating employee recognition initiatives to identify and reward risk 'culture carriers' across the organisation

GOVERNANCE

- Defining the bank's overall risk appetite, including developing its risk appetite statement
- Delivering leadership capability training for the c-suite, executive, and middle management, focused on driving cultural best practice outcomes
- Reviewing organisational structures and employee reporting lines to maximise individual accountability and ownership
- Refining HR recruitment policies (such as background screening protocols) to ensure effective risk profiling of candidates

COMMUNICATION

- Redesigning employee training programmes (including both content development and engagement mechanisms) to engender a more fundamental shift in risk mindset
- Reviewing whistle-blower protocols to encourage reporting of employee misconduct in a disciplined and safeguarded manner
- Advising on appropriate RegTech solutions to streamline the risk reporting process, including the design of best-practice dashboards and organisational risk scorecards
- Revamping internal communication strategies to simplify key messaging and drive employee engagement and awareness

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STRATEGY WITH A DIFFERENCE

ABOUT US

Quinlan & Associates is an independent strategy consulting firm specialising in the financial services industry.

We are the first firm to offer end-to-end strategy consulting services. From strategy formulation to execution, to ongoing reporting and communications, we translate cutting-edge advice into commercially executable solutions.

With our team of top-tier financial services and strategy consulting professionals and our global network of alliance partners, we give you the most up-to-date industry insights from around the world, putting you an essential step ahead of your competitors.

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CONTACT US

@ info@quinlanandassociates.com | www.quinlanandassociates.com | (+852) 2251 8725

Level 19, Two International Finance Centre, 8 Finance Street, Central, Hong Kong SAR