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Input by Transparency International to Fair and Effective Markets Review

Responsibilities, governance and incentives

Q36: How much of a role did inadequate governance, accountability and incentive arrangements play in the recent FICC market abuses, and to what extent do these remain potential vulnerabilities in FICC markets globally? In addition to on-going regulatory changes, what further steps can firms take to embed good conduct standards in their internal processes and governance frameworks? And how can the authorities, either internationally or domestically, help to reinforce that process, whether through articulating or incentivising good practice, or through further regulatory steps?

When looking into the collusion of traders from UBS, HSBC, Royal Bank of Scotland, JPMorgan Chase and Citigroup to manipulate the foreign exchange rate the FCA regulators found a "free for all culture" on trading floors. Bankers clearly lacked ethical awareness and were solely focussed on making profit for their own gain or for that of their institution in total disrespect of the interests of other market participants or stakeholders. While individuals are of course responsible for their own actions it is widely recognised that the culture and the incentive system in banks currently encourages this kind of behaviour.

A recent study shows that the prevailing business culture in the banking industry weakens and undermines honesty.[1] This view is confirmed by financial services professionals themselves close to one third of which (29%) believe that they may need to engage in unethical or illegal activity in order to be successful.[2] Furthermore, more than one-quarter (26%) believed the compensation plans or bonus structures in place at their companies incentivize employees to compromise ethical standards or violate the law.[3]

A culture of integrity in the financial sector is crucial to restore trust among customers, shareholders, regulators and citizens given the role of the banking sector in promoting a stable and healthy global economy. It is worrisome that the foreign exchange rate manipulation scandal could happen after the Libor scandal had been revealed. It shows that despite the commitments by CEOs post-Libor banks have not been successful in addressing conduct risks and that there is still a long way to go.

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[1] Cohn, Alian, Fehr, Ernst and Maréchal, Michel André (2014): Business culture and dishonesty in the banking industry, http://www.nature.com/nature/journal/v516/n7529/full/nature13977.html

[2] Labaton Sucharow's U.S. Financial Services Industry Survey (July 2013): Wall Street in Crisis: A Perfect Storm Looming, http://www.labaton.com/en/about/press/Wall-Street-Professional-Survey-Reveals-Widespread-Misconduct.cfm

[3] Labaton Sucharow's U.S. Financial Services Industry Survey (July 2013): Wall Street in Crisis: A Perfect Storm Looming, http://www.labaton.com/en/about/press/Wall-Street-Professional-Survey-Reveals-Widespread-Misconduct.cfm

A recent survey reveals that over two-thirds (66%) of banks are currently implementing changes to their culture, but 91% of employees say that cultural change is still very much a work in progress.[4] While the tone from the top has changed, the main challenge is mainstreaming the envisioned new culture of less risk for short-term profit, but more customer focus and transparency, accountability and integrity throughout the company.

Transparency International has identified 7 key areas for a culture of integrity in the banking sector with recommendations for actions for banks and regulators in each area.

1) Tone from the top

Studies have shown that culture is the biggest determining factor for employee conduct and that directors directly affect the culture of their company through their actions and messages.[5] A strong, visible and active commitment by senior management and the board is indispensable for ethical and risk aware behaviour to be mainstreamed throughout the company. The behaviour expected by employees should be clearly stated in a code of conduct as well as a risk appetite statement. Formal policies and procedures such as codes of conduct and risk appetite statements can have a strong impact on corporate culture provided that:

- They are publicly and unambiguously embraced by the firm's management;
- They are clear and consistent with the firm's internal and external communication;
- They are continuously reviewed and updated;
- Staff is properly and periodically trained through tailored programs;
- They assign clear roles, responsibilities and accountability channels;
- They include clear and strict guidelines on operational risk appetite, in particular for conduct risks;
- Their implementation is supervised by an independent body (or as part of the compliance department) reporting directly to the board, which is responsible for remedial or disciplinary actions.

<u>Recommended regulatory action:</u>

- Hold senior management and the board accountable for failures in the corporate governance system.
- Mandate the appointment of one Board member to be responsible and accountable for conduct and customer risk issues.

2) Incentive system

Levels and structures of remuneration can incentivise staff towards particular types of behaviour, e.g. experts agree that short-sighted incentives have greatly amplified the excessive risk taking that led to the collapse of the global financial system in 2009. A large part of bankers' total compensation is determined by cash bonuses, stock options and other benefits, which in most cases exceed the base salary. Metrics

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[4] Ernest & Young: 2014 Risk Management Survey of Major Financial Institutions. Shifting Focus. Risk Culture at the Forefront of Banking, http://www.ey.com/GL/en/Industries/Financial-Services/Banking---Capital-Markets/ey-shifting-focus-risk-culture-at-the-forefront-of-banking

[5] „2009 National Business Ethics Survey: Ethics in Recession," Ethics Resource Center, November 18, 2009, cited in: ERC, „Ethical Leadership and Executive Compensation", March 2010, p. 11.

for remuneration and performance evaluation have largely failed to account for conduct risks and non-financial performances, relying exclusively on quantitative profit targets.

In order to incentivize integrity banks should ensure that:

a) With regard to remuneration

- Financial and non-financial performance metrics should have equal impact on compensation and promotion decisions. When certain behaviours pose a risk to the company's values, this should override assessments of financial performance.
- Remuneration should reflect long-term performance and discourage short-term excessive risk-taking. There should be an appropriate balance between long and short-term incentives to give executives a personal interest in the firm's longer-term performance.
- Banks should make full use of claw back and malus options. Banks should not grant the option of buying out deferred awards in case the chief executive or other top-level executives leave.
- Remuneration policies should be approved by shareholders. Remuneration policies and annual reports on compensation should be publicly available and comprehensible to an informed but non-specialist reader.

b) With regard to other human resources (HR) tools

- Behavioural and risk management criteria should be mainstreamed throughout all aspects of human resources (HR), from the recruitment process to compensation, performance management, training, career advancements and assignment of benefits.
- Recruitment should be fair and subject to objective and transparent criteria. Recruitment should focus on highly qualified individuals with unquestioned commitments to integrity.
- Compliance officers should possess relevant experience and competencies and receive a compensation scheme comparable to other operative departments. For the employment of previous public officials a cooling off period of at least one year and commensurate to the risk should be respected.
- There should be continuous and mandatory training of staff (including board members) on integrity, anti-money laundering, conflicts of interest and other operational risks.
- Sanctions for wrongdoing should be clearly communicated and transparently implemented.

<u>Recommended regulatory action:</u>

- Regulators should encourage banks to have an incentive system that promotes behaviour in the interest of society. One relevant tool could be partial payment of bankers in performance bonds with senior management and material risk-takers on a bank's staff forfeiting these bonds if their behavior resulted in fines. This would create incentives for employees to report wrongdoing early and it would also shield shareholders from bearing the cost for wrongdoings by management.
- Regulators should introduce an "ethics and compliance score card" for banks employees enabling banks to look up individuals' past performance when making hiring decisions. This would incentivize individuals to behave ethically.

3) Conflicts of interest

The financial industry is extremely vulnerable to conflict of interests, in particular insider trading. To properly address conflicts of interest banks should:

- Provide staff with guidance on what constitutes inappropriate use of information and have processes in place for identification, disclosure and management of conflicts of interest.
- Have robust controls in place, including the monitoring of communications.
- Regularly update comprehensive anti-bribery policies and procedures.
- Introduce disciplinary actions for violations.
- Physically separate certain functions, e.g. implementing fire walls to prevent collusion between investment bankers and brokers as well as between traders and rate setting teams.

Recommended regulatory action:

- Introduce clear standards on identification, disclosure and management of conflicts of interest in regulatory codes.
- Impose statutory restrictions on retail assets' management and on intra-group loans.

4) Effective monitoring

Although most banks have monitoring structures such as an independent internal audit function in place they can easily become a tick the box exercise without a matching incentive system and corporate culture. In order to incentivize compliance banks should:

- Equip the compliance function with greater authority and prestige by ensuring that
    - it reports directly to the board,
    - receives compensation similar to other operative departments,
    - possesses sufficient resources and staff who are competent to identify risks in the business, ideally with experience as a banker.
- There should be clear policies for misconduct, including dishonest trading
- Ensure a range of accessible and reliable internal and external disclosure channels that provide for safe, secure, confidential and anonymous disclosures.

Recommended regulatory action:

- Ensure prompt, effective and independent follow-up of disclosures and complaints and full legal remedies for whistleblowers who have been retaliated against.
- Internal monitoring should be accompanied by strict and efficient external auditing and regulatory oversight.
- Make market abuse a criminal offense with high penalties for individuals proportionate to the seriousness of the crime and the damage caused.
- Industry-wide codes of conduct enforced by an independent body and endorsed by formal regulatory bodies may increase the effectiveness of oversight, avoid "first mover's disadvantages" and establish a level playing field

5) Anti-money laundering regulation

Integrity risks can also stem from bank's customers. If banks do not want to become complicit in laundering the proceeds of corruption, organised crime and tax evasion they should:

- Proactive steps must be taken in order to identify and verify the identity of customers, including beneficial owners, relying on multiple sources. In case of corporate clients, detailed and periodically updated documents on ownership and control structures must be obtained. When this is not possible, no business relationship shall be established.
- Particularly stringent checks must be carried out on high-risk customers, i.e. PEPs, high-net worth individuals, customers performing transactions for a third party, non-face-to-face customers and complex, obscure offshore-based corporate or trust arrangements.
- Measures and policies to address money laundering-related risks should be embedded in the bank's general risk framework.

Recommended regulatory action:

- Ensure the capacity and resources of regulators are commensurate to the financial activity to be monitored.
- Work with Financial Intelligence Units to develop red flags to identify Politically Exposed Persons (PEP) and provide guidance and feedback to reporting institutions on submitted Suspicious Activity Reports.
- Adopt sanctions severe enough to act as deterrents.
- Apply penalties when controls, procedures and processes by financial institutions are deemed inadequate, even if money laundering is not found.
- Ensure increased personal responsibility for senior officials at banks who fail to uphold PEP regulations.

6) Transparency

Given their critical role in the global economy, banks have a special responsibility to be accountable to stakeholders, including shareholders, customers and citizens. Transparent financial and non-financial reporting is fundamental in ensuring trust and accountability.

- Banks should be transparent about their organizational structure and publish lists of their subsidiaries, joint ventures, sponsored off-balance sheet vehicles and other related entities.
- Banks should publish individual financial accounts for each individual country of operation.
- Board and management should be responsible for ensuring that financial statements are prepared in accordance with internationally accepted accounting rules, fairly reflecting the group's financial condition and performance, risk exposures and risk management strategies. All off-balance sheet activities should be included in a consolidated financial document,

Recommended regulatory action:

- Mandate country-by-country reporting of financial information in the financial services sector.

Firm-wide initiatives to improve incentives and governance

*Q37: Do respondents' agree that the thematic areas highlighted in Section 5.5 are key priorities for FICC firms (**fine-tuning performance measures; adjustments to remuneration; attitudes towards hiring, promotion and advancement; closer board involvement in governance of FICC activities; and clearer front line responsibilities**)? What specific solutions to these challenges have worked well, or could work well? And how best can the authorities help to support these initiatives?*

See reply to Q36