In the aftermath of the global financial crisis, many different cases of malfeasance and corruption at banks have been exposed. To date, settlements worth more than US$ 230 billion have been agreed between banks and national authorities to rectify abuses. At the heart of this crisis is a break-down of integrity.

Banks have a strong impact on the safety and soundness of the world’s financial system, and the overall economic health of countries. The most recent financial crisis (2007-08) revealed these interlinkages and triggered many reform efforts, yet problems have continued. A range of recent settlements have shown that major banks remain involved in scandals — from money laundering to rate rigging and tax evasion — that undermine the public’s trust in financial institutions.

Now is the time to restore trust in banks. Banks provide an essential public function for society. As any company, a bank has the right to operate based on national law and legal frameworks. Banks have a duty to uphold public trust over private gain as part of their license to operate that society has granted them. In addition, many banks have a specific indebtedness to society following the massive bail-outs they received from tax-payer money.

To rebuild trust, Transparency International believes that far greater attention needs to be paid to non-financial risks, including those posed by a bank’s conduct, its customers and the corporate culture. The importance of a strong anti-bribery programme in setting the right ethical tone cannot be overstated. But it must be reinforced by efforts in five key areas to create a culture of integrity: the promotion of ethical behaviour, better management of conflicts of interest, rigorous anti-money laundering checks, more effective monitoring and greater transparency. Individuals and senior management also should be held accountable for wrongdoings in cases of serious misconduct or personal involvement in illegal behaviour.

Any solution must be a joint effort by the banking industry, regulators and supervisory bodies. Transparency International looks to banks to publicly report on the measures they have taken in these areas and to monitor their impact. For their part, regulators should undertake periodic integrity stress tests of banks in each of the five identified areas and make public the results.
Corruption risks which affect the banking sector can be customer-related (e.g. money laundering) or conduct-related (e.g. risks stemming from improper behaviour by employees and management). Many cases of corruption in the banking sector can be described as abuse of public trust for institutional gain at the expense of society. This type of behaviour is encouraged by a corporate culture that focusses on short-term profit-making and does not properly incentivise ethical or lawful behaviour.

A large body of research shows that a company’s organisational culture is the largest influence on employee conduct. According to one recent study, the prevailing business culture in the banking industry tends to favour dishonest behaviour to a significantly higher degree as compared to other sectors. Based on a 2015 survey of financial services professionals, nearly 20 per cent feel that it is at least sometimes necessary for them to engage in an illegal or unethical activity to succeed. In reaction to recent financial scandals, more institutions are paying greater attention to non-financial risks. However, more than 90 per cent of those interviewed in the same study admit that a cultural change is “still very much (a) work in progress”.

The failure to properly take into account conduct and customer risks can be extremely costly for banks, both in terms of reputational and financial damages. Since 2009 fines imposed on the industry for misconduct currently amount to US$ 232 billion and are expected to rise above US$ 300 billion by 2016. In addition, banks have suffered deep and long-term reputational losses through the ongoing scandals. Recurring scandals have stirred uncertainty among bank shareholders, business partners and customers. The public’s overall impression is that the banking sector is more concerned with large short-term profits made through excessive risk-taking than with its societal purpose of providing credit to ensure a stable, sound economy.

Creating a healthy corporate culture of integrity in the banking sector would lead to better financial performance of individual companies and the entire sector in the long term by improving risk management and promoting trust. The shift demands determined and continued commitment by bank directors and senior managers. A profound cultural change also requires the criminal prosecution of individuals for wrongdoings, right up to senior management. To implement a culture of integrity in banks, Transparency International believes that the following five areas are among the key elements that need to be put in place.

THE SOLUTION

1. AN INCENTIVE SYSTEM FOR INTEGRITY

The first area that is needed to create a culture of integrity is a bank’s incentive system. It has to reinforce anti-corruption and anti-bribery compliance policies and promote ethical behaviour. The incentive system encompasses three key pillars: the tone which is set by senior managers from the top, remuneration and human resource (HR) management practices.

Tone from the top

A company’s culture is set from the top. According to many business researchers, culture is the largest influence on employee conduct and directors greatly influence the ethical culture of their company. Formal documents such as codes of conduct, risk appetite and value statements provide guidelines for staff behaviour but can be meaningless paper exercises if they are not actively enforced.

BANKERS UNDER OATH

A public oath can be an effective instrument to send a clear message to employees on what type of behaviour is expected from them.

In the Netherlands, bank employees must swear an oath - optionally to God - promising they will perform their duties with integrity and that they will “endeavor to maintain confidence in the financial sector.” This is part of an effort by the Dutch Banking Association and the Dutch government to restore trust in the sector which is at an all time low. This follows the government spending more than 95 billion euros of tax payer money in capital and guarantees over the past six years in order to bail banks out following various allegations of mismanagement and wrongdoings.

This “banker’s oath” was once simply self-regulation but it is now also included in the Dutch statute books. The oath must be adhered to by a total of 90,000 bank employees in the Netherlands.

Dutch bankers also are to be subject to disciplinary laws. Employees who fail to abide by the new rules may be blacklisted and face fines or suspensions.

To be most effective, such oaths should be combined with other related measures (such as a detailed code of conduct tailored to each bank and effective sanctions for non-compliance).
maintained by senior managers and the board. To avoid giving mixed messages to employees, all actions the company takes must be in line with its stated objectives and values.

Many chief executives of financial institutions have committed themselves to cultural changes following the recent market rigging scandals. To make this commitment credible, however, senior management and the board should clearly communicate to employees that their highest priority is to operate at all times within the law and to the highest ethical standards. The “tone from the top” should insist that operations should never benefit the bank or specific clients at the explicit expense of other customers. It should also convey that employees at all levels work in ways that promote strong values and compliance with the anti-corruption and anti-bribery programme.

The promotion of cultural change within banks has to be mainstreamed throughout middle management and the entire organisation. Promoting integrity requires not only senior managers, but heads of department and every employee to lead by example.

Areas for Action

- Institute visible and active commitments by senior management and the board to integrity and ethical behaviour and to the implementation of a policy that prohibits bribery and corruption.
- Spell out the behaviour expected of employees in a code of conduct, as well as a risk appetite statement. Related policies should assign clear roles, responsibilities and accountability channels and also offer clear and strict guidelines on operational risk appetite. In addition, they should be:
  - Clear and consistent with the company’s objectives, values and its internal and external messages;
  - Publicly and unambiguously embraced by management;
  - Continuously reviewed and updated;
  - Mainstreamed through proper and periodic training of staff;
  - Supervised by an independent body that reports directly to the board (e.g. the compliance department) and is responsible for the administration of remedial or disciplinary actions.

Remuneration

A large amount of bankers’ total compensation is determined by variable payments such as cash bonuses, stock options, pensions and other benefits, which in most cases exceed the base salary. The criteria on which remuneration is based can incentivise staff towards particular types of behaviour.

Until recently, indicators for performance management have largely failed to account for non-financial performance such as behaviour or compliance, relying exclusively on short-term quantitative profit targets. This contributed to integrity failures. According to a 2015 survey of professionals working in financial services, a third of those surveyed said compensation structures or bonus plans pressure employees to compromise ethical standards or violate the law. To avoid these integrity failures, staff should be rewarded for sustainable risk management that includes compliance with the law, zero tolerance for anti-corruption and bribery, and ethical behaviour.

Most recently, some banks have revised their remuneration metrics giving more weight to non-financial performance criteria. An increasingly common practice is the adoption of “balanced scorecards”, a strategic planning and management system which adds strategic non-financial performance measures to traditional financial metrics. To encourage long-term planning, several banks have also
EU LEGISLATION ON REMUNERATION

In an effort to reduce reliance on short-term incentives, the European Union (EU) has introduced a cap on variable pay.

This limits it to the amount of one’s fixed salary, unless decided otherwise by shareholders, in which case the amount can be equal up to twice one’s fixed salary (Directive 2013/36/EU on Capital Requirement - CRD IV).

However, one negative side effect of the cap has been a weakened link between performance and compensation. Financial institutions in turn simply have raised their base fixed salary.

begun to defer bonuses paid to executives. Yet research shows that bonuses deferred for too long are not taken into account by bankers.

In the US, the Dodd-Frank Act now requires the disclosure of remuneration metrics and of the CEO’s pay ratio, the creation of an independent compensation committee and a non-binding shareholder vote on executive compensation. In response, many banks have increased the board’s involvement in remuneration decisions and created or strengthened remuneration committees.

Another widely adopted reporting standard, the Global Reporting Initiative (GRI), calls for the transparency of remuneration policies of financial institutions as well as stakeholder involvement in determining them. Furthermore, banks should report on how performance criteria in the remuneration policy relate to their economic, environmental and social objectives.

Areas for Action

- Establish non-financial performance criteria for all employees (up to senior management) that are equally important to financial performance criteria when determining performance-related pay. This shift will help to place a premium on one’s integrity, behaviour, and compliance with a company’s anti-bribery and corruption programme. When certain behaviours pose a risk to a company’s values, these actions should override any positive assessment of financial performance and be penalised.
- Give executives a personal interest in the company by ensuring an appropriate balance between long- and short-term performance incentives.
- Make full use of claw back and malus options.
- Publish remuneration policies as well as stakeholder involvement in their determination. Report on how performance criteria relate to a company’s economic, environmental and social objectives.

Recruitment and training

Sound and rigorous hiring policies are important for a culture of integrity. In the financial industry, there have been cases of nepotistic recruitment and revolving doors between the public and the private sector. Both of these can lead to conflicts of interests that need to be managed transparently. It is crucial that selection processes at all levels ensure that newly recruited employees have integrity and, in particular for the more senior positions, the adequate skills and experience necessary to carry out their duties. Furthermore, there should be ongoing and regularly updated employee trainings on how to operate with integrity, including on issues such as anti-money laundering, conflicts of interest and other non-financial corruption risks.

Areas for Action

- Mainstream criteria related to integrity, behaviour and anti-corruption compliance throughout all aspects of human resource (HR) management (e.g. from the recruitment process to compensation, performance management, training, career advancement and benefits).
- Ensure that recruitment is rigorous and subject to objective and transparent criteria. Recruitment should focus on highly qualified individuals with unquestioned commitments to integrity.
- Respect a cooling off period of at least two years and that is commensurate to the risk in the employment of former public officials.
- Conduct continuous and mandatory training of staff (including board members) on integrity, anti-corruption, anti-money laundering, conflicts of interest and other non-financial risks.
2. CONFLICTS OF INTEREST

The second important element for a culture of integrity is effective management of conflicts of interest. In the banking sector, insider trading is the most common conflict of interest. For example, investment bankers can make inappropriate use of confidential information regarding one of their client companies. This is done by advising other clients to trade this company’s stock—a practice which in the end is to the benefit of the investment bank. To address this risk, investment banks are required to separate their investment banking and brokerage operations by erecting information barriers or so-called “Chinese walls”. Yet these efforts have not always been sufficient to prevent conflicts of interest.21

Following the financial crisis, the Volcker Rule in the US partially reinstated the separation between the investment and commercial functions of banks.22 This was to address the “moral hazard” created when large global banks were considered “too big to fail” due to their interconnectedness to the global economy and bailed out with public money. Given ongoing banking scandals, a separation of these functions should continue to be considered.

Conflicts of interest can also take place within a company’s investment banking division. In recent years, traders have colluded to manipulate the Libor and foreign exchange rate markets. In one instance, a trader set up a complex system of bribe payments to fellow employees, counterparts at other banks and inter-dealer brokers to manipulate the yen Libor. At least 45 bank employees, including managers, were aware of this practice.23

Finally, conflicts of interest can occur if public officials and civil servants move to lucrative private sector positions, where they may use their government experience and connections to unfairly benefit their new employer. They may also move the other way, taking government jobs that help to benefit their previous employer.24 Cooling off periods therefore should be respected when switching between sectors (see side bar).25

The UK’s 2014 “Fair and Effective Markets Review” identified the following best practices to deal with conflicts of interest: provide staff with guidance on what constitutes inappropriate use of information; put robust controls in place, including the monitoring of communications; introduce disciplinary actions for violations; physically separate certain banking functions; and introduce clear standards on identification and management of conflicts of interest in regulatory codes.26 Some of these are noted below.

Areas for Action

- Provide clear guidance to staff about what constitutes the inappropriate use of information and put processes in place for the identification, disclosure, monitoring and management of actual or perceived conflicts of interest.
- Introduce robust controls on conflicts of interest, including the monitoring of communications and clearly communicate and implement disciplinary actions for violations.
- Regularly update comprehensive anti-bribery policies and procedures.
- Physically separate front, middle and back offices on trading floors and ensure effective surveillance.

3. ANTI-MONEY LAUNDERING

Rigorous anti-money laundering policies and procedures are the third important element to build a culture of integrity in banks. A bank’s client base presents serious risks. Through its clients, a bank might become complicit in laundering the proceeds of crime, including corruption.
Several customer groups present increased risks for banks, demanding enhanced due diligence. For example, these include high net-worth individuals, people with dubious reputations or corporate clients with complex or opaque ownership structures. Another high-risk type of customer are so called Politically Exposed Persons (PEPs). These are people who are entrusted with high public functions as well as the public official’s relatives, business partners and other close associates.27 For high-risk customers banks have the duty to identify the owner and (legitimate) source of funds before entering into any business relationship. A bank also must continue to conduct periodic monitoring of those clients. If they identify suspicious activities, banks are obliged to report them to the relevant national authorities.28

In practice, compliance with anti-money laundering rules — especially with regard to PEPs — is extremely low. A World Bank report in 2010 found that only two per cent out of 124 assessed jurisdictions were fully compliant with existing standards on PEPs.29 Presumably, this is due to many factors including capacity issues, mismanagement of risks and, in some cases, deliberate complicity driven by the lure of short-term profits. A public register that captures the beneficial ownership information of companies would assist banks in performing their due diligence duties. The UK has recently passed relevant legislation to create such a registry.30 Furthermore, the EU has introduced a central register to track this information as part of its Fourth Anti-Money Laundering Directive.31 Another proposal is to reverse the burden of proof for PEPs and require PEPs to prove the legitimate source of their wealth before being able to open a bank account.

Financial institutions should be fully cooperative in official investigations to combat money laundering, such as from funds linked to stolen assets. Once stolen assets have been placed in the banking system, recovery is extremely complex. It can be difficult to locate funds concealed in a web of multiple accounts with multiple layers of secrecy. Freezing assets that have been identified as stolen can be slow. In addition, cross-jurisdictional investigations can be challenging and expensive. It is estimated that 99 per cent of illicit funds remain undetected and 0.2 per cent of all funds uncovered have been seized.32

**Areas for Action**

- Conduct enhanced due diligence measures prior to establishing a business relationship with a high-risk customer.
  - Draw on a range of sources to vet clients: commercial and in-house databases, information exchanges within the company group, asset declaration filings, internet and media, among others.
  - Include steps to verify the sources of wealth and funds.
  - Identify the beneficial owner (in cases of corporate clients or trust arrangements).
  - Request a copy of the PEP’s asset declaration, when applicable.
  - Require high-risk PEP clients to prove the legitimate source of their funds and do not enter a business relationship should they be unable to do so.
  - Ensure senior management approval.
- Embed measures and policies to address money laundering-related risks in the bank’s general risk framework.
- Train staff on how to identify and address money laundering risks, including the “red flags” that are defined by international standards and company-specific risk profiles.
- Fully cooperate in investigations to recover stolen assets.
4. EFFECTIVE MONITORING AND ACCOUNTABILITY

The fourth important element to create a culture of integrity in banks is the effective monitoring of policies that promote integrity — and that can ensure accountability when there is wrongdoing. The needed paradigm shift in corporate culture is not possible without accountability. This can be promoted by clearly defining the costs to individuals who engage in wrongdoing, including criminal prosecution, if applicable.

Monitoring and accountability should take place both within a bank and by regulators. Within a bank, external regulations are too often adopted and applied at the minimum required level. When compliance is not integrated in the broader corporate culture it becomes a “tick-the-box” exercise with high costs and little efficiency. Compliance officers also often lack the necessary authority and support within the bank to detect and fully investigate wrongdoings. The Office of the Comptroller of the Currency of the US Treasury recommends equipping compliance staff with authority, prestige, better compensation and, most importantly, both independence from and support from the top management, with direct access to the board.

Responsibility for complying with a bank’s rules and values should not be left exclusively to compliance or audit departments. Traders and relationship managers are in the best position to observe, prevent and report misconduct as they are the closest to clients and their transactions. As a first line of defence, employees must be able to blow the whistle and report misconduct through accessible, safe and confidential disclosure channels (both internal and external). Many of the scandals in recent years at banks have been uncovered due to the courageous actions of whistleblowers. However, not only recently there have been efforts to stifle reporting (e.g. through confidentiality agreements or retaliation against whistleblowers). It is important that financial institutions promote an open culture that encourages individuals to report wrongdoing.

At the supervisory level, an effective sanctions regime for wrongdoing is crucial. Operating a bank is a privilege granted by the state through licensing. Banks have corresponding responsibilities to the public. The most effective deterrent for wrongful behaviour may likely be the prosecution of individuals, including senior management, if applicable. Yet, an overall trend is to punish wrongdoing in the banking sector through settlements, resulting in large corporate fines with little accountability for individuals (see side bar). For example, less than 10 individuals were sanctioned by British financial regulators in 2014.

To address this weakness, banks must strengthen lines of accountability up to senior management and the board, who may have failed in their oversight duty or even condoned wrongdoing in some cases.

Several legislative initiatives aim to increase individual accountability. In the UK, the draft Senior Management Compliance regime will require banks to regularly vet senior managers for their propriety and improve responsibility lines at the top, enhancing the regulator’s ability to hold senior individuals to account. In addition, there are efforts in the UK to make market abuse a criminal offence to address recent rate-rigging scandals. Furthermore, the EU Criminal Sanctions Market Abuse Directive has introduced new and harmonised standards, including jail sentences for offences such as insider trading and market manipulation. The Fourth EU Anti-Money Laundering Directive includes the requirement to nominate one Board member as responsible for anti-money laundering.
Areas for Action

- Nominate one Board member who is responsible for overseeing policies and procedures related to customer and conduct risk.
- Equip employees exercising a compliance function with greater authority and prestige by ensuring that they:
  - report directly to the board,
  - receive compensation similar to other functional departments,
  - possess sufficient resources including competency to identify risks in the business.
- Establish clear policies for misconduct, including dishonest trading.
- Clearly communicate and implement sanctions for wrongdoing.
- Ensure a range of accessible and reliable internal and external disclosure channels for whistleblowers that provide for safe, secure, confidential and anonymous disclosures.
- Continuously monitor and review related policies and procedures and publicly report on progress made.

5. TRANSPARENCY

The fifth important element in building a banks’ culture of integrity is transparency. Given the critical role banks play in the global economy, they have a responsibility to be accountable to shareholders, regulators, customers and citizens. Transparency in the reporting of their financial and non-financial information is fundamental in creating trust.

In the EU, new reporting requirements have been legislated to require credit institutions and investment firms to report on profits made, taxes paid and subsidies received for each financial year and geographic location. This greater transparency will allow for greater corporate accountability towards society and assist shareholders in making informed choices about risks they face.

Just as any company, financial institutions should publicly report on their anti-corruption policies, be transparent about their organisational structure, and report key financial information on a country-by-country basis. However, major financial institutions worldwide perform poorly when it comes to transparency.41

To identify industry-wide best practices, financial institutions should monitor and publicly report on any ongoing initiatives in the five important areas that have been identified for building a culture of integrity. Given its interconnectedness, the entire sector will benefit from seeing the reputation gains and cost savings achieved through corporate integrity initiatives. For their part, regulators should push for change by undertaking regular integrity stress tests in the five areas and publishing the results. To achieve fundamental change and restore trust in financial institutions, industry-wide collective action is needed, including by financial institutions, regulators and civil society.

Areas for Action

- Publish the companies’ organisational structure and subsidiaries, joint ventures, sponsored off-balance-sheet vehicles and other related entities.
- Report on anti-corruption policies.
- Publish financial accounts for each individual country of operation the company has.
- Report on any initiatives in the five above mentioned areas for promoting a corporate culture of integrity.
NOTES

4 Ernst & Young, “Shifting focus. Risk culture at the forefront of banking,” 2014.
5 Ibid
8 EY’s 2015 fraud survey shows that businesses that have experienced revenue growth in the last two years are more likely to have effective compliance policies and procedures in place.
9 See foot note 2
10 For example, statements by Citigroup, JPMorgan, HSBC, UBS and RBS following the settlement on the foreign exchange rate manipulation scandal. http://www.business-standard.com/article/international/big-banks-fined-3-3-bn-by-uk-us-swiss-regulators-114111300031_.html
11 Ernst & Young, “Shifting focus. Risk culture at the forefront of banking.” 2014.
13 A balanced scorecard is implemented for example by HSBC and Sainsbury’s Bank.
14 Ernst & Young, “Incentives: the good, the bad and the risky,” 2013. In the EU rules allow for the application of a discount rate to a maximum of 25% of the total variable pay, provided it is in the form of instruments deferred for at least 5 years.
16 Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, Secs 953 & 956.
19 For instance, in 2013 JP Morgan Chase was probed for alleged nepotistic recruiting practices in China (nicknamed “Sons and Daughters” program), aimed at securing business opportunities in the country by hiring family members of the local elite.
21 For example, a 2014 study shows a quarter of mergers & acquisitions are preceded by insider trading. Augustiny et al. (May 2014), Informed Options Trading prior to M&A Announcements: Insider Trading?
24 For example, the former European Commissioner for the digital agenda becoming special adviser to the Bank of America Merrill Lynch, http://corporateeurope.org/revolvingdoorwatch/cases/neelee-kroes.
25 For example, David Aufhauser, who was the General Counsel of the U.S. Department of Treasury, then became Managing Director of UBS AG. In addition, later on he was found to be involved in insider trading and had to pay a US$ 6.9 Million fine. http://blogs.wsj.com/law/2008/10/07/aufhauser-former-ubs-fined-insider-trading-allegations/.
27 Current regulations require enhanced checks only for foreign PEPs, but revised standards are starting to include domestic PEPs on a risk-assessment basis. See the 2012 FATF recommendations n. 12.
28 Financial Action Task Force (FATF) recommendations. FATF has made it clear that enhanced risk management by banks requires greater due diligence and not wholesale de-risking.
29 The New York City Office of the Comptroller, “Incentives and preventive measures in the banking sector.”
32 EU AMLD IV: See: www.transparency.org/news/pressrelease/eu_agrees_money_laundering_transparency_reforms_but_full_access_denied
34 A 2011 study by the UK Financial Conduct Authority showed that around three quarters of banks in are not always managing high-risk customers and PEP relationships effectively.
38 Bank of England Fair and Effective Markets Review.
39 Directive 2014/57/EU.
40 EU AMLD IV.
41 TI, Transparency in Reporting Against Corruption (2014).
Editor: Angela McClellan


Printed on 100% recycled paper
© 2015 Transparency International.
All rights reserved.

Note: Research compiled by Matteo de Simone