vigeo eiris
Rating

# *Responsibility and ethical culture in banking and finance*

SUSTAINABILITY FOCUS

*June 2017*

Vigeo Eiris
Rating

# Key takeaways

*The ongoing and serious cases of misconduct in banking and finance sectors since the financial crisis of 2008-2009 undermine trust in financial markets and threaten banks' license to operate.*

*A strong ethical culture is considered essential to make banks less prone to misconduct. Financial regulators and industry bodies have launched several initiatives to reduce the risk of further misconduct, by launching culture reform initiatives and improving accountability and controls.*

*Vigeo Eiris research shows that a minority of the global banks has taken concrete steps to support, promote and communicate a responsible business culture:*

- *Almost three quarters of banks in our sample report to integrate CSR risks in their internal controls, but less than 40% have strong processes in place to manage those risks*
- *While three quarters of banks identified staff considered as 'material risks takers', only one fifth introduce conduct related performance metrics within their remuneration policies*
- *Only one third of banks instituted formal training programs on the prevention of business ethics risks and clearly support an internal culture of responsible business conduct.*

*Recurrent and serious controversies have also been identified during the 2016 diversified banks sector review since:*

- *57.7% of banks were involved in controversies related to mis-selling of financial products*
- *73% of them were involved in cases related to manipulation of financial markets*
- *82.3% of them faced compliance breaches controversies*

# Introduction

*Since the financial crisis of 2008-2009, banks across the world have been involved in several conduct-related scandals. All these cases - from mis-selling of financial products to violation of national and international regulations and manipulation of financial markets - highlight how* ***banks appear to be unable to change their internal cultural norms since the financial crisis****. According to the Group of Thirty (G30), a forum of leaders in international finance, "banks are, to varying degrees, still failing to implement desired ethics, values, and behaviors, and weaknesses in embedding values and codes of conduct for all staff are widespread."*[1]

*In February 2015, the Financial Stability Board (FSB) published a letter to the G20 Finance Ministers and Central Bank Governors highlighting that* ***"the scale of misconduct*** *in some financial institutions has risen to a level that* ***has the potential to create systemic risks****". The FSB estimated that "fundamentally, it threatens to undermine trust in financial institutions and markets."*[2] *Again, two years after, in March 2017, the FSB reaffirmed in a letter to the same audience that "numerous instances of misconduct in the financial industry in recent years have damaged confidence in financial institutions and undermined trust in markets. The implications of misconduct can be far-reaching, limiting the potential of finance to serve real economies and to foster global economic growth.*[3]*"*

*This Sustainability Focus investigates the efforts done by the global banks with total assets of at least EUR 200 billion in promoting a culture of responsible business conduct. In particular, the paper covers the latest data (from November 2015 to December 2016) for 52 diversified banks in Europe (31 companies), North America (12 companies) and Asia-Pacific (9 companies).*

1 Group of Thirty - Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform - July 2015 - p29

2 Financial Stability Board (FSB) - FSB Chair's Letter to G20 on Financial Reforms – Finishing the Post-Crisis Agenda and Moving Forward - 4 February 2015

3 Financial Stability Board (FSB) - Chair's letter to G20 Finance Ministers and Central Bank Governors ahead of their Baden-Baden meeting - 17 March 2017

vigeo eiris
Rating

# Vigeo Eiris findings

Within the Diversified Bank sectors, commitments and measures taken to prevent misconduct and disseminate a culture of ethical behavior are analysed in the following sustainability drivers

- **'Audit & internal controls',** which covers the integration of CSR risks (including ethical misconduct) within the banks' internal control framework as well as measures deployed to monitor and manage material risk takers[1];
- **'Executive remuneration',** which analyses the remuneration policies implemented to incentivise ethical conduct by senior executives and other material risk takers;
- **'Prevention of corruption and money laundering',** which deals with the involvement of employees in preventing business ethics risks and promoting a culture of responsible business conduct;
- **'Information to customers',** which addresses training and awareness raising about responsible marketing for sales and marketing staff.

Results from Vigeo Eiris' analysis related to the **integration of business ethics risks within the banks' internal control framework** show that CSR related risks are part of the internal controls for almost all diversified banks under review. In particular, ethical misconduct and non-compliance risks are covered by internal controls for almost three quarters of the banks (73.1%, equal to 38 banks). However, **only 38.5% of the panel (20 companies) have implemented relevant/strong processes** (balanced scorecard, risk-related training, monitoring of key risk indicators, risk mapping, systems to report to the Board, a board committee overseeing CSR risks) to manage such risks.

Looking at how the misconduct risks have been addressed, 73.1% of the companies disclose the process of **identification and supervision of material risk takers;** but only for 19.2% of the group analysed (ten companies) is there evidence that training on risk management for material risk takers is provided and/or their performance and remuneration are reviewed by the risk management function.

1 The CEBS 2010 Guidelines require financial institutions to identify the staff members whose remuneration is subject to specific stricter requirements. This group of employees, named 'Material Risk Takers' or 'Identified staff', includes executives, senior managers and independent control functions and 'other risk takers', such as staff members whose professional activities – either individually or collectively, as members of a group – can exert influence on the institution's risk profile (such as individual traders, specific trading desks and credit officers).

This definition is, however, very general and it is not surprising that financial institutions have applied it quite loosely. In fact, the European Banking Authority (EBA)'s 2012 survey revealed that the numbers of identified staff vary considerably between member states, but in general it is very low. The banking authority expressed genuine concern about this finding, since different and insufficient application of the remuneration guidelines could lead to serious regulatory arbitrage and competitive disadvantages.

In light of these results, on 21 May 2013 the EBA issued a consultation paper proposing a clearer definition of "Identified Staff" under the CRD IV remuneration requirements (including a cap to annual bonus). The identification process proposed by the EBA is based on a mix of internal criteria, regulatory qualitative and quantitative criteria (e.g. variable remuneration exceeds 75 % of the fixed component of remuneration and EUR 75,000), with an employee identified as "Identified Staff" if he/she met at least one of these three criteria

*Société Générale*

The variable remuneration pools of material risk takers are determined by business line on the basis of, among others, qualitative factors such as market practices, conditions under which activities are carried out and risk management, through an independent appraisal process performed by the Risk and Compliance Divisions, essentially for the Global Banking and Investor Solutions and International Banking and Financial Services activities. The allocation of individual variable takes into account annual individual appraisal based on the achievement of quantitative and qualitative objectives known to the employee, further complemented by an evaluation on risk management and compliance carried out by the Risk and Compliance Divisions. The Audit and Internal Control Committee gives the Compensation Committee its opinion on the incorporation of risk within the compensation structure for regulated employees (financial market professionals and others).

With regard to the remuneration policies and the introduction of conduct related performance metrics, while CSR objectives appear to be considered in the determination of variable remuneration for senior executives in 18 banks (34.6%), **performance indicators related to business ethics** are observed only in ten banks (19.2%). However, among these, only **BNP Paribas**, **The Royal Bank of Scotland** and **Barclays** disclose the related quantitative targets.

Regarding the **risk alignment of remuneration** and the adoption of mechanisms to limit the short-termism of the compensation policies, only one third of the diversified banks (17 companies) deferred at least 60% of variable remuneration of top senior executives and, among these, only five banks introduced longer deferral periods, up to five years[1].

*BNP Paribas*

In order to be in line with the Bank's new CSR strategy, the CSR management indicators, which were set to expire in 2015, have been redefined for the period 2016-2018 and the Group has taken on new quantitative commitments for this period:

- Share of loans to companies subject to an environmental and social management system which is specific to the concerned activity (2018: 40% targets compared to 15% of 2015);
- Yearly number of beneficiaries of micro-credits allocated by microfinance institutions financed by BNP Paribas (350,000 by 2018, compared to 250,000 in 2015);
- Percentage of employees trained on an ethics-related issue (More than 80% by end-2018);
- Percentage of women among the members of transversal executive committees across business lines and/or countries (23% by 2018, compared to 21% in 2015).

*Barclays*

Indicators considered for the Balanced Scorecard were assessed by the Remuneration Committee and include:

- Ranking in Relationship Net Promoter Score against peer sets Client Franchise Risk: to be ranked 4th in the Relationship Net Promoter V peer sets Client Franchise Risk;
- Engagement with employees: employees survey's score 82-88% and share of women in senior leadership at 23%;
- Development and progress of community involvement initiatives: complete 11 of the planned programs;
- Score in Conduct Reputation: YouGov Survey score of 5.6/10.

1 For European banks, the EBA observed in 2013 that for the 'identified staff' the requirements in terms of risk alignment of remuneration remain largely unapplied. According to the 2010 Guidelines, a substantial portion of the variable remuneration component of 'identified staff' should be **deferred over an appropriate period of time,** which is not less than three up to five years. These proportions should increase significantly along with the level of seniority and/or responsibility.

Similar results can be found once the scope of our analysis moves from the material risk takers to the whole staff and investigates the banks' efforts to disseminate a business ethics culture. Indeed, **only one third** of the Diversified Banks (17 companies) instituted formal training programmes for relevant employees on the prevention of business ethics risks but also **clearly support an internal culture of responsible business conduct.**

The reluctance displayed by the sector to embrace a more proactive approach to business ethics is further worsened by the **serious and recurrent controversies which banks are involved in.** These can be grouped in three different categories:

1. Mis-selling of financial products to retail customers and investors (such as the US subprime mortgage-backed securities, the payment protection insurance mis-sold by UK banks);
2. The manipulation of financial markets (such as the manipulation of interbank interest rates and foreign exchange rates);
3. Compliance breaches in terms of corruption, money laundering, taxes, economic sanctions etc.

According to the 2016 review of Diversified Banks sectors,

- 57.7% of the banks are involved in controversies related to **mis-selling of financial products** and, among these, 13 companies (equal to a quarter of the sample) are involved in recurrent and serious controversies.
- 73% of the banks are involved in controversies related to **manipulation of financial markets** and, among these, 21 companies (equal to 40.4% of the sample) are involved in recurrent and serious controversies.
- 82.7% of the banks are involved in controversies related to **compliance breaches** (such as breaches of money laundering regulations, violations of economic sanctions, etc.) and, among these, 29 companies (equal to 55.8% of the sample) are involved in recurrent and serious controversies.

# Cases of good practices in diversified banks

## EUROPE

### BNP Paribas

The Culture Risk initiative includes awareness-raising e-learning courses completed by more than 52,000 employees around the world. The impact of the Culture Risk program has been measured by the 2015 Employee Satisfaction Survey that included a question on employees' opinion about the Culture Risk action plan and its adequate implementation within the teams to avoid any damage to the Group's reputation (and on which 80% answered positively).

The Group Executive Committee has also decided to launch a Culture & Conduct group-wide program, approved by the Board of Directors in January 2016. The program is under the sponsorship of the Group General Management, and aims at putting Culture and Conduct at the heart of the operational management of the business. The main deliverable will include, notably: (1) the definition of Société Générale Conduct rules, and of appropriate behaviors; (2) the implementation of a group-wide dedicated communication plan; (3) the integration of Conduct and Culture in all HR levers (recruitment, training, evaluation, compensation, sanctions).

### Crédit Agricole

As part of its Medium-Term Plan 'Strategic Ambition 2020', the Group is adopting a new approach to compliance. It must become a differentiating asset by taking a central place in the organization and the Group's values. For this, four projects are launched on the organization and governance of the Compliance Business Line: reporting line to management, training, recruitment, and treatment of alerts. Two other projects concern the development of Compliance Culture internally and for customers. Finally, important industrialization works will be developed to introduce the concept of compliance from the beginning of the process: simplification of procedures for customers, claims, customer database, etc. To this end, Credit Agricole Group will invest over the next 4 years EUR 1bn in strengthening the Group's compliance and risk mitigation".

### UBS

During 2015, the Group's employees and external staff were required to complete over 800,000 mandatory training sessions, an increase of approximately 14% from 2014; approximately 65% of these sessions were produced by Compliance and Operational Risk Control (C&ORC). As a rule, the training sessions need to be completed, usually together with an assessment, within a specified deadline. Failure to complete mandatory training sessions satisfactorily within the given deadline results in consequences including disciplinary action.

At the beginning of every year, the firm's business goals are translated into individual performance and behavior goals, strengthening the alignment between corporate and employee priorities. The year-end review process measures not only what was achieved, but also how those results were achieved. Since 2013, UBS has specified the behaviors it expects and has embedded them into performance evaluations. In 2015, UBS introduced separate ratings for goals and behaviors to further emphasize the importance of integrity, collaboration and challenge in daily business activities, as well as transparency in the management and reward processes. Both goal and behavior ratings factor into development, reward and promotion decisions.

## NORTH AMERICA

### Canadian Imperial Bank of Commerce

Each year, all employees are required to complete formal training on risk appetite, reputation risk, code of conduct, anti-money laundering and other risk topics. The aim of this mandatory training is that all employees develop a basic knowledge of risk management in support of CIBC's risk culture. In addition to this, the bank commits to communicate all material related to risk culture (i.e. risk appetite statement, risk management priorities, principles, policies and procedures) through the internal website and internal news releases.

## ASIA PACIFIC

*Australia & New Zealand Banking Group Ltd.*

All employees and contractors are required to undertake mandatory training to ensure awareness and understanding of their obligations relating to fraud, bribery and corruption, money laundering and sanctions, in order to prevent breaches. All employees and contractors must refresh their knowledge of specific courses within the programme, once annually, or every two or three years, depending on the subject. Failure to do mandatory learning can lead to disciplinary action.

Every three years, employees are required to complete 'Preventing Fraud and Corruption' training. employees at management level and above must declare they have read and understood 'The Blue Book' – ANZ's guide to Code of Conduct and Ethics, standards and behaviours, and important policies and procedures. Compliance is a Key Result Area (KRA) examined as part of ANZ's Performance Development Process: failure to complete required compliance training can be a factor in the employee's entitlement to performance-based remuneration and could lead to termination of employment in serious cases.

# Misconduct and its implications

## ESTIMATED FINANCIAL COSTS

Figures may vary according to the source yet all point to substantial costs. According to the 2015 report from the European Systemic Risk Board (ESRB), misconduct allegations cost the banking sector around EUR 200 billion between December 2009 and December 2014. More recently, in May 2016, the European Central Bank (ECB) estimated that cumulative legal costs (including damages, fines, settlements and litigation costs) at a sample of 26 global banks headquartered in the United States, the United Kingdom, Switzerland and the Euro area have reached almost USD 275 billion between 2008 and mid-2016. In the case of European banks, provisions for legal costs amounted to USD 160 billion, which represents almost half of European banks' net income earned between 2008 and 2015[1].

## NON-FINANCIAL COSTS

In addition to the legal and financial damages, misconduct-related allegations create reputational and political risks that could threaten banks' license to operate. Misconducts could damage **confidence in financial markets and institutions,** discouraging "users of financial services from utilising the system" and "limiting the potential of finance to serve real economies and foster global economic growth". Likewise, **misconduct by banks imposes costs on society**. "For example, mis-selling of financial products leads to a suboptimal allocation of investments and risks (as witnessed in the years preceding the financial crisis) and manipulation of financial markets distorts the proper functioning of these markets, allowing banks to profit from undue rents. Misconduct related to tax evasion has a direct impact on state revenues and misconduct related to money laundering undermine the efforts of states to enhance global security.[2]"

## INITIATIVES FOR REMEDIATION

Financial regulators and industry bodies have launched several initiatives to reduce the risk of future misconduct by, launching culture reform initiatives and improving accountability and controls.

In May 2015, the **FSB** launched a **misconduct action plan** to address these issues through a range of preventative measures, focusing on:

1. improvements to financial institutions' governance and compensation structures to reduce misconduct risk;
2. improvement to global standards of conduct in the fixed income, commodities and currency markets, including through codes of conduct and through related regulatory and enforcement tools in wholesale markets; and
3. reforms to major financial benchmark arrangements to reduce the risks of their manipulation. Indeed, the rationale behind this action plan is based on the conviction that "the use of fines and sanctions acts as a deterrent to misconduct, but preventative approaches are also needed that can mitigate the risk of misconduct through improved market organisation, structure and behaviour of market actors." [3]

1 European Central Bank (ECB) - Financial Stability Review. Special Features - May 2016 – p9, p11

2 European Systemic Risk Board (ESRB) - Report on misconduct risk in the banking sector - June 2015 – pp3-4

3 Financial Stability Board (FSB) - Measures to reduce misconduct risk. Progress Report - 6 November 2015 – p1

The European Banking Authority (EBA) also considers now misconduct and its costs. Since 2016, the EU-wide stress test has included the impacts of conduct risks such as fines and settlements, requiring banks to project operational risk losses when applying their internal risk models, but subject to strict floors based on their loss experience. In particular, additional guidance and reporting requirements were established for material conduct risk events, focusing primarily on interaction between bank supervisors and banks and featuring, for example, mis-selling, market manipulation and money laundering[1].

Since the emerging of financial crisis, most industry-wide initiatives were focused on reviewing and implementing a more effective risk culture. However, **besides a robust risk culture, a strong ethical culture is likewise essential to make banks less vulnerable to misconduct.** As recognized by the Group of Thirty, "poor cultural foundations and significant cultural failures were major drivers of the recent financial crisis, and continue to be factors in the scandals since then, exacerbated by staff with questionable conduct and values who move from bank to bank with impunity". However, "improving and embedding desired conduct and cultural norms is a long-term process that requires a sustained effort. […] Banks should work to fully embed the desired culture through ongoing monitoring and perseverance, drawn from four key areas: senior accountability and governance, performance management and incentives, staff development and promotion, and an effective three lines of defense"[2].

UK regulators have been the most active globally in terms of accountability and governance. In March 2016, the **Bank of England** and the **Financial Conduct Authority** introduced a **Senior Managers Regime (SMR)** establishing requirements for firms to certify that their employees are 'fit and proper' to perform their jobs. The Senior Managers Regime focuses on the most senior individuals in firms who hold key roles or have overall responsibility for whole areas of relevant firms. Firms need to:

1. ensure each Senior Manager has a Statement of Responsibilities setting out the areas for which they are personally accountable;
2. produce a Firm Responsibilities Map that knits these together and
3. ensure that all Senior Managers are pre-approved by the regulators before carrying out their roles.

In the event that there is a regulatory breach in an area assigned to an individual senior manager, there is a "presumption of responsibility", whereby the senior manager concerned is held responsible for that breach: he/she - faces a regulatory/civil sanction, unless it can be proven that he/she took "reasonable steps" to prevent the breach from occurring. If a senior manager's recklessness causes a firm to fail, he/she may face criminal sanctions, including a custodial sentence.

To ensure that the desired conduct and values are embedded within the company, banks have started developing rigorous **performance reviews** to ensure that they do not reward individuals who do not meet a threshold of acceptable behavior in alignment with a firm's values and conduct expectations. Additionally, efforts are required to align **compensation** with conduct related performance metrics, including "consequences for weak management oversight or willful blindness"[3].

1 EBA said the total hit from conduct costs was 71 billion euros. The largest impact was from credit or losses on loans, totaling nearly 350 billion euros across all the banks tested. [European Banking Authority (EBA) - EBA – 2016 EU-wide stress test. Results – 29 July 2016 – p30]

2 Group of Thirty - Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform - July 2015 – p5, p13

3 Group of Thirty - Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform - July 2015 – p13

# Conclusion

*Overall, a strong ethical culture is considered essential to make the banks less vulnerable to misconduct.*

*However, **the promotion of desired conduct and values is a long-term process which involves the whole organization** and requires that measures are taken in terms of accountability and governance, remuneration and performance review, and training.*

*As highlighted by this Sustainability Focus, despite serious controversies, **only a minority of the Diversified Banks has really started taking steps in these areas.***

*In general, the banks still appear slow in anticipating and adapting to the recommendations and regulations issued by national and international actors.*

*However, beyond regulations, the increased awareness of the public opinion and the stronger activism of shareholders will in the next years increasingly push banks to be more proactive in dealing with misconduct risks.*

*Author:*

**Roberto Savia**

ESG Analyst

*This study was witten under the direction of:*

**Fouad Benseddik**

Director of Methods and Institutional Relations

**Valérie Demeure**

Head of Thematic Research

**For more information:**

Press contact: Anita Legrand - anita.legrand@vigeo.com / +33 1 55 82 32 44

General information: Amélie Nun - amelie.nun@vigeo.com / + 33 1 55 82 32 77

Vigeo Eiris is a global provider of environmental, social and governance (ESG) research to investors and public and private corporates. The agency evaluates the level of integration of sustainability factors in the strategy and the operations of organizations and undertakes a risk assessment to assist investors and companies in decision-making.

Vigeo Eiris offers two types of services through separate business units:

- **Vigeo Eiris rating** offers databases, sector-based analyses, ratings, benchmarks and portfolio screening, to serve all ethical and responsible investment strategies.
- **Vigeo Eiris enterprise** assesses organizations of all sizes, listed and not listed companies in order to support them in the integration of ESG criteria into their business functions and strategic operations.

Vigeo Eiris methodologies and rating services adhere to the strictest quality standards and have been certified to the independent ARISTA® standard. Vigeo Eiris is CBI (Climate Bond Initiative) Verifier.

Vigeo Eiris is represented in Paris, London, Boston, Brussels, Casablanca, Milan, Montreal, Santiago, Stockholm and Tokyo. The team is composed of more than 200 experts of 28 nationalities with diversified and complementary skills. Vigeo Eiris has developed the “Vigeo Eiris Global Network” made of 6 research providers (Australia, Brazil, Germany, Japan, Spain and Mexico).

For more information: www.vigeo-eiris.com

All rights reserved. Reproduction and dissemination of material in this report for educational or other noncommercial purposes are authorised without any prior written permission from Vigeo SAS provided the source is fully acknowledged. Reproduction of material in this report for resale or other commercial purposes is strictly prohibited without written permission of Vigeo SAS.

Produced and designed by Vigeo SAS