WORKING PAPER
02 / 2015

TRANSPARENCY INTERNATIONAL
the global coalition against corruption

INCENTIVISING INTEGRITY IN BANKS

In the aftermath of the global financial crisis, a wide range of 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.

To create a greater culture of integrity, banks must promote ethical behaviour in their incentive systems accompanied by better management of conflicts of interest, rigorous anti-money laundering checks, more effective monitoring and greater transparency.

Banks have a strong impact on the safety and soundness of the world's financial system, and the overall economic health of countries.[1] 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.[2] 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.

THE ISSUE
CORRUPTION IN THE BANKING SECTOR

Corruption risks which affect the banking sector can be customer-related (e.g. money laundering of the proceeds of corruption or criminal acts) or conduct-related (e.g. risks stemming from improper behaviour by a bank's employees and management such as insider trading or market rigging). Many cases of corruption in the banking sector can be described as abuse of public trust for institutional gain at the expense of society.[1] 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 organizational culture is the largest influence on employee conduct.[2] 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.[3] 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.[4] 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 work in progress".[5]

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.[6] In addition, banks have suffered deep and long-term reputational losses through the ongoing scandals.[7] 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.[8] 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

Tone from the top

- Institute visible and active commitment 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

- 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 in compensation decisions 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 related performance criteria relate to a company's economic, environmental and social objectives.

Recruitment and training

- Mainstream criteria related to integrity, behaviour and anti-corruption compliance throughout all aspects of human resources (HR) management (e.g. from the recruitment process to compensation, performance management, training, career advancements and assignment of 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 culture, integrity, risk principles, anti-corruption, anti-bribery, anti-money laundering, conflicts of interest and other non-financial risks.

2. CONFLICTS OF INTEREST

- Provide clear guidance to staff about what constitutes an inappropriate use of information using case studies 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

- Conduct enhanced due diligence measures prior to establishing a business relationship with a high-risk customer (e.g. PEPs, high-net worth individuals and complex, opaque offshore-based corporate or trust arrangements).
    - 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

- 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

- 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: an incentives structure that promotes ethical and compliant behaviour, effective management of conflict of interests, rigorous anti-money laundering checks, robust monitoring and accountability and transparency towards stakeholders.

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[1] Salter, Malcom S. (2010). Lawful but Corrupt: Gaming and the Problem of Institutional Corruption in the Private Sector. Harvard Business Working Paper 2010.
[2] Barnett, T. & Varcys, C. (2000). The moderating effect of individuals' perceptions of ethical work climate on ethical judgments and behavioural intentions. Journal of Business Ethics, 27(4), 351-362; Dickson, M., Smith, D., Grojean, M. & Ehrhart, M. (2001). An organizational climate regarding ethics: The outcome of leader values and the practices that reflect them. Leadership Quarterly, 12(2), 197-217; Trevino, L., Butterfield, K., & McCabe, D. (1998). The ethical context in organizations; Influences on employee attitudes and behavior. Business Ethics Quarterly, 8(3), 447-476; Dickson, M., Smith, D., Grojean, M. & Ehrhart, M. (2001). An organizational climate regarding ethics: The outcome of leader values and the practices that reflect them. Leadership Quarterly, 12(2), 197-217.
[3] A. Cohn, E. Fehr, M. A. Maréchal, "Business culture and dishonesty in the banking industry." Nature 2014.
[4] Ernst & Young, "Shifting focus. Risk culture at the forefront of banking," 2014.
[5] Ernst & Young, "Shifting focus. Risk culture at the forefront of banking," 2014.
[6] James Titcomb, "The banking industry's bill for bad behaviour: 300bn," *The Telegraph*, 13 November 2014.
[7] 2014 Makovsky Wallstreet Reputation Survey
[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.