ETHICS

Rolling the Dice on Ethics

Banks are gambling with their compliance programs if they aren't considering ethics

BY MICHAEL BERMAN

IF SOMEONE FLIPS A COIN TWO TIMES IN A ROW, there's a 25 percent chance that the coin will land on heads or tails two times in a row—that is, unless the coin flipper is reporting the results anonymously.

Then the odds of success are much higher. That's what Japanese researchers found when they promised study participants a $5 coupon book if they flipped a coin twice and it landed on the same side twice in a row (**link.springer.com/article/10.1007/BF03395662**). Those who didn't have to write their names on the results sheet were twice as likely to report they'd won more than those who were instructed to identify themselves (46 percent vs 21 percent).

Some people lied to get the prize, but the study also showed some people lied just because they could. Even when participants weren't promised a prize, those who reported anonymously won at a statistically unlikely rate (35 percent).

The good news for human nature is that most study participants told the truth. The bad news is that a significant segment of the population didn't. For those people, lack of oversight and accountability gave them a green light to engage in dishonest behavior. If there is something to gain by behaving unethically, whether it's financial or emotional, some people will exploit the opportunity.

This is true everywhere, including in the field of compliance. Compliance officers and departments are tasked with ensuring everyone at the institution is engaging in compliant behavior, yet the industry is riddled with stories of bankers who've taken short cuts and ignored rules and responsibilities to get ahead.

It's not just a failure of compliance. It's a failure of ethics, or the principles or values that govern behavior. The two are so intertwined that the U.S. Justice Department's Evaluation of Corporate Compliance Programs frequently refers to a company's "compliance and ethics program" (**www.justice.gov/criminal-fraud/page/file/937501/download**).

When a bank doesn't actively promote ethical behavior across the enterprise, compliance is neglected.

Common examples include:

- Incentives that encourage noncompliance
- Poor leadership
- Bad behavior begetting more bad behavior
- Conflicts of interest
- Inconsistent enforcement

There's no need to create an experiment to test compliance ethics in the banking world. There are plenty of examples.

Dis-incentivizing Compliance

Consider a study in American Sociological Review, of the use of the riskiest derivatives at 157 of the largest U.S. banks between 1995 and 2010 (**scholar.harvard.edu/files/dobbin/files/asr2017.pdf**). CEOs given cash bonuses for performance were far more eager to exploit derivatives and push chief risk officers to take on more risk than CEOs compensated with company stock.

If the investment went south, CEOs paid in cash had already made their money, giving them little incentive to set or adhere to any sort of risk appetite or tolerance. It encouraged a shortterm outlook instead of creating an environment of long-term ownership and responsibility. It eliminated accountability.

When a stakeholder thinks he has little to lose and plenty to gain for his actions, he will often make a bad decision. But as any compliance professional knows, just because

someone thinks there's no risk to engaging in noncompliant behavior doesn't mean there aren't consequences. When compliance is ignored, an institution is also ignoring the broad range of potential negative side effects.

Poor Leadership

In 2013, British banking firm Barclays hired a firm to study its culture after it was caught manipulating the London Interbank Offered Rate (LIBOR) and the Euribor by misreporting its borrowing costs with management's blessing. (See **online.wsj.com/public/resources/documents/SalzReview04032013.pdf**.)

The Salz Review, as it came to be known, blamed the bank's culture, finding that Barclays rarely promoted values across the whole organization. Employee evaluations made no mention of values or ethics and the board received little information about the bank's culture. Employees who spoke up were ignored.

Staff follow the cues of their leaders. If leaders don't encourage ethical behavior, or worse yet, encourage unethical behavior, most employees will go along.

Bad Behavior Begets Bad Behavior

Unethical behavior is contagious. Once bad actors get a toehold in an institution, they attract others like them.

Good employees aren't going to refer their friends and acquaintances to a workplace they aren't proud of or confident in, due to widespread noncompliance. The bad ones will, spreading the word to other scammers and slackers comfortable with unethical behavior and reinforcing a negative culture.

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Conflicts of Interest

In 2017, a bank director at a small community bank got in trouble with the Office of the Comptroller of the Currency for allegedly failing to properly oversee the CEO's compensation. She knew he had a history of using bank funds for personal expenses yet did nothing to stop him from doing it again, costing the bank over $1 million. As a member of the compensation committee, the director approved a base salary 85 percent higher than the highest-paid CEOs at peer banks. (See **www.occ.gov/static/enforcement-actions/ea2017-047.pdf**.)

Why would the director do this? She had lent the CEO $2 million, a fact that she didn't disclose to other board members and should have caused her to recuse herself from voting on his compensation, the OCC says.

The agency also had a few words about the CEO, describing him an overbearing executive who was "rarely challenged credibly by other executive members of the Bank." He voted as a member of the compensation committee to give himself a raise, hired his son-in-law as controller and his successor before getting board approval, and

paid his daughter $60,000 a year to work remotely even though she had another full-time job, the OCC says. (See **www.occ.gov/static/enforcement-actions/eaN16-002.pdf**.)

A bank's board needs to be independent with no conflicts of interest so it can objectively evaluate performance. Those with financial relationships, including as an investor, customer, or vendor, may be tempted to make decisions in their own best interests instead of the institution's. Those with close relationships to management may be unduly influenced by friendship or past employment.

A good working relationship with management is essential, but that doesn't mean greenlighting every decision without thought.

Inconsistent Enforcement

People are more likely to misbehave if they don't think they'll be caught or get into trouble. There needs to be clear consequences for noncompliant behavior and everyone at the bank must be held accountable.

If a person or business line believes that rules don't apply because they are too important, too smart, too busy or have a close relationship with someone higher-up, they won't feel compelled to follow policies and procedures that support compliance. Similarly, if they think they'll get off with a friendly reminder to please try and do better and it won't impact their performance reviews, promotions or compensation, they won't be particularly concerned about doing things correctly.

Building an Ethical Culture

The Federal Reserve Bank of New York has spent years studying how to improve the culture at financial institutions and holds an annual culture conference (**www.newyorkfed.org/newsevents/mediaadvisory/2019/0522-2019**). It has distilled culture into three key issues:

1.Defining and clarifying purpose to create clear goals for assessing performance. A bank's purpose should "emphasize sustainable success, not short-run

profit." Customers should be at the center of business decisions. Stewardship should be a value of the institution.

This purpose needs to be clearly communicated by the board, which needs to follow up with management to ensure they are leading in a way that supports the institution's purpose. There must be consequences for those that stray.

2.Measuring how firms and the industry are performing. A bank needs to know if it's achieving its purpose and how it compares to its peers. Standardized metrics can be useful tools that assess behavior and culture while including behavior in performance reviews can help influence behavior.

William C. Dudley, president and CEO of the Federal Reserve Bank of New York thinks the industry would benefit from a "common culture survey" to benchmark behavior (**www.newyorkfed.org/newsevents/mediaadviso-ry/2019/0522-2019**). Taking inspiration from an annual review of the United Kingdom's Banking Standards Board, he'd like to see banks ask whether employees agree with statements like:

- "I believe senior leaders in my organization mean what they say."
- "In my organization we are encouraged to follow the spirit of the rules—what they mean, not just the words."
- "I see people in my organization turn a blind eye to inappropriate behavior."
- "If I raised concerns about the way we work, I would be worried about the negative consequences for me."

3.Determining whether incentives encourage behaviors consistent with goals. Incentives need to align with behaviors that will support long-term business goals. For example, a bank that ties bonus goals to having no exam findings may not be promoting compliance. Management may instead feel incentivized to under report compliance violations and other issues.

The benefit of this is two-fold, according to an article in the Delaware Journal of Corporate Law. There is the obvious problem of employees putting their own careers and monetary gain ahead of customer and institutional needs. The other problem is that incentives and policies that encourage employees to look out for their own interests

instead of the institution can attract "individuals with anti-social traits" which can then rile up others and spread across an institution.

Banks need to demonstrate that they have no tolerance for unethical conduct. They need to communicate expectations, enforce those expectations consistently for employees at all levels and swiftly discipline those who fail to take their compliance responsibilities seriously. Employees should feel comfortable raising concerns.

The Justice Department notes that sharing disciplinary actions can deter unethical behavior while promotions. Well-thought-out rewards and bonuses tied to compliance metrics and ethical leadership are tools to incentivize compliance.

Incubating Ethics with Transparency

Transparency incubates ethical behavior. When policies, procedures, expectations are clearly communicated and activities are conducted and documents out in the open, it creates an environment where it's harder to choose to engage in unethical behavior. There are no corners to hide in.

This can be accomplished with:

▪ **Independent reviews.** It's not enough to have a compliance process. The institution needs to be sure it has a compliance management system that's effective and supports the banks business strategies and goals. Every step of the process needs to work effectively, including policies, reporting, resources and controls. If an institution isn't meeting its compliance objectives, senior management needs to tell the board so it can decide whether to deploy new resources or consider a new approach. That's why independent reviews are so important. A pair of fresh eyes can uncover oversights and help overcome groupthink.

▪ **Documentation.** If it's not written down, it didn't happen. A bank should keep all compliance documentation organized. This includes everything produced by the board, management and employees. Documents should be up to date and readily available to facilitate oversight, accountability, monitoring, and risk management.

▪ **Oversight and accountability.** Successful compliance management requires clearly defined roles and responsibilities. Where individuals responsible have the knowledge,

sufficient authority and resources to administer an effective program, along with mechanisms to integrate compliance into the bank's everyday activities. The Board, senior management and staff each have a role to play, and there needs to be a way to track their responsibility and accountability.

Under no circumstances should a Chief Compliance Officer (CCO) be the only person at the bank tasked with managing compliance. It's an enterprisewide endeavor, one that benefits from the management and expertise of a talented CCO but that requires a team effort to be effective. This person must be a relationship builder who is respected and empowered to communicate about risks and expect cooperation.

An institution's employees are responsible for monitoring compliance and informing senior management of issues. Not only should they be properly trained to follow policies and procedures, but their knowledge should be leveraged to improve compliance policies and procedures.

Building an ethical culture and having the tools in place to track and monitor behavior, creates an environment where compliance is equipped for success, and opportunities for engaging in unethical behavior are limited.

No bank should leave compliance up to a flip of a coin. The stakes are too high.

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