



Universiteit
Leiden
The Netherlands

Banking on team ethics : a team climate perspective on root causes of misconduct in financial services

Scholten, W.W.

Citation

Scholten, W. W. (2018, March 29). *Banking on team ethics : a team climate perspective on root causes of misconduct in financial services*. *Dissertatiereeks, Kurt Lewin Institute*. Retrieved from <https://hdl.handle.net/1887/61392>

Version: Not Applicable (or Unknown)

License: [Licence agreement concerning inclusion of doctoral thesis in the Institutional Repository of the University of Leiden](#)

Downloaded from: <https://hdl.handle.net/1887/61392>

Note: To cite this publication please use the final published version (if applicable).

Cover Page



Universiteit Leiden



The handle <http://hdl.handle.net/1887/61392> holds various files of this Leiden University dissertation

Author: Scholten, Wieke

Title: Banking on team ethics : a team climate perspective on root causes of misconduct in financial services

Date: 2018-03-29

A grayscale image of a petri dish containing several bacterial colonies of varying sizes and textures, including a prominent one with a fuzzy, hair-like appearance.

Part I
Misconduct

Chapter 1
Misconduct within banking: a current,
continuous and serious problem

Chapter 1

Misconduct within banking: a current, continuous and serious problem

1. A current and continuous problem

Since the fall of Lehman Brothers in September of 2008, often marked as the start of the economic crisis, multiple misconduct cases in the trading business that involve unethical behaviour have come to the eyes and ears of the public. In 2013 for instance, the manipulation of London Interbank Offered Rate (Libor) was painfully illustrated by explicit emails between traders who manipulated the Libor. The Libor reflects the rates at which banks borrow money from each other each day and influences what these banks charge their customers (Finel- Honigman & Sotelino, 2015). The emails between traders manipulating Libor revealed neglect of the general public's interests (Box 1), since financial products like mortgages and other loans depend on the Libor, and manipulation of the Libor therefore determines how much the public pays for these financial products. These email exchanges clearly show the traders were aware that their behaviour was fraudulent but considered this to be 'normal' in trading (e.g. *"We're dirty-clean No one's clean-clean"*).

Even though many attempts were made to address and mitigate misconduct in the trading business, partly as a result of the financial crisis, misconduct in trading is not a problem of the past. Also after 2008, multiple frauds by traders have received public attention and even reached court rooms (see Table 1.1). There is reason to believe more cases exist than the ones that are publicly known. Prudential and integrity supervision within the banking sector pay close attention to cases such as these, as they continue to emerge also today.

Box 1. Libor manipulation: emails between traders

Below fragments of emails between traders and submitters of Barclays, one of the banks involved in the Libor manipulation. These emails were published by several media in the summer of 2013.

- *"I have a huge 1m fixing today and it would really help to have a low 1m tx a lot.": "I'll do my best."*
- *"For you ... anything..."; "Always happy to help, leave it with me, Sir," , "Done ..for you big boy.."*
- *"[Senior Trader] owes me!"; "Dude. I owe you big time! Come over one day after work and I'm opening a bottle of Bollinger."*
- *"If you know how to keep a secret I'll bring you in on it," "We're going to push the cash downwards on the imm day..."*
- *"If you breathe a word of this, I'm not telling you anything else..."*
- *"This is the way you pull off deals like this, don't talk about it too much, 2 months of preparation ... the trick is you must not do this alone ..."*
- *We're clean, but we're dirty-clean, rather than clean-clean., "No one's clean-clean."*

The problems identified in Table 1.1 are not contained within a specific organization, and continue over time despite increased regulatory scrutiny and supervision. This leads to at least two conclusions. The first is that misconduct in this sector is a current and ongoing problem. As a (ex-) financial supervisor I am bound to confidentiality, and not in the position to give recent examples of misconduct cases that have not (yet) been made public. That having been said, my own experiences as a financial supervisor, and the continuous attention financial supervisors have for integrity supervision and misconduct prevention, give rise to the statement that the cases in Table 1.1 cannot be seen as exceptions to the rule, nor do they represent ‘tales from the past’.

Table 1.1 Five publically known large misconduct cases perpetrated by individual traders, before and after the onset of the financial crisis in 2008 (as described in Finel-Honigman & Sotilino, 2015).

Trader	Bank	Year*	Summary of misconduct	Consequence for bank	Consequence for trader
1 Nick Leeson	Barings (Singapore desk)	1995	Creating fictitious accounts to cover up losses, resulting from taking excessive risks.	Barings was sold to ING for the symbolic GB£1.-.	Sentenced to 6.4 years in jail – served four.
2 Jérôme Kerviel	Société Generale (Delta desk)	2008	Creating fictitious reports or claiming error has occurred, to cover up losses, resulting from taking excessive risks.	Trading loss: €4.9 billion. Société Générale was accused of lax risk management and poor supervisory controls.	Sentenced to 3 years in jail – served 100 days.
3 Kweku Adoboli	UBS (Exchange traded funds desk)	2011	Placing unauthorized trades, betting on stock markets. Using an ‘umbrella account’ to hide evidence. Using profit to cover up gambling debts.	Fined GB£29.7 million by the UK FSA.	Sentenced to seven years in jail – served four.
4 Bruno Iksil	JP Morgan (London desk)	2012	‘The London Whale’: building a synthetic credit portfolio, proprietary position. Manipulating valuations of the portfolio to cover up losses.	Trading loss: US\$6.2 billion. JP Morgan incurred fines and penalties of over US\$2 billion.	Fined, not sentenced to jail.
5 Tom Hayes	Several banks were involved in LIBOR; Hayes worked at RBS and Citi.	2015	Manipulation of the London Interbank Offered Rate (Libor). Hayes is the first trader involved that is sentenced.	The next paragraph provides an overview of fines to banks involved in LIBOR, under “Business perspective: costs of misconduct”.	Sentenced to 14 years in jail, in December 2015 lowered to 11 years.

* Year of court ruling.

The second conclusion that can be drawn from Table 1.1 is that misconduct cases constitute a continuous problem, and seem to repeat over time. This implies that the problems identified are not contained within a specific banking organization, and suggests that it is not easy for those in practice to learn effectively from prior occurrences of similar problems elsewhere. An example is the lesson that could have been learned from the Leeson case in 1995: it is risky to grant traders access to back office operations, while at the same time taking trading positions. Thus, a more general conclusion could have been that such combined discretions should not be assigned to a single individual. Yet, in 2008 Kerviel and in 2011 Adoboli, both junior traders, had access to back office operations to cover up their questionable investments – just as Nick Leeson had. These cases also involved back office manipulation of accounts and creation of false accounts, but could have been prevented if (junior) traders had not been offered such access to back office operations after the Leeson case had come to light (Finel-Honigman & Sotelino, 2015).

In the next section, I will elaborate on why such misconduct is not only current and continuous, but also a serious problem – by elucidating its detrimental consequences and broader implications for the financial sector and as a factor that may undermine economic stability.

2. Detrimental consequences

Misconduct of traders has detrimental and negative consequences for a bank; from a business perspective, as well as a legal perspective. I will elaborate on each below.

Business perspective: costs of misconduct

From a business perspective, misconduct is costly. There are several reasons for this. First, the trading losses as a direct result of the misconduct are often massive. The Société Generale case of 2008 (see Table 1.1) resulted in a trading loss of €4.9 billion; the London Whale case led to a trading loss of US\$6.2 billion.

Second, banks are faced with high fines – imposed by courts and regulators – and settlements - arranged with prosecutors. Illustrative of the height of fines is that these fines in the US exceeded US\$25 billion in 2012, which included fines for fraudulent mortgage back securities transactions (JP Morgan, Bank of America, Goldman Sachs and UBS), and the manipulation of Libor (Barclays, Rabobank and RBS) (Finel-Honigman & Sotelino, 2015). For Europe, the same trend is observable. Between 2010 and 2015, fines imposed in Europe have been increasing, reaching a cumulative total of around EUR 200 billion for all banks and EUR 50 billion for EU banks (Finel-Honigman & Sotelino, 2015). Taking the Libor scandal as an example, the settlement between the implicated banks and US and UK regulators, by October 2013, had reached US \$1.5 billion for UBS, US\$450 million for Barclays and US\$615 million for Rabobank. Further, the European Commission fined Deutsche Bank €259 million; RBS €260 million and JM Morgan €80 million for the attempted manipulation of the Libor and Euribor rates (Finel-Honigman & Sotelino, 2015).

Third, misconduct often forces banks to set aside additional capital and cover litigation and redress costs. As a result of the Libor case for instance: Swiss regulators ordered UBS to increase by 50% the amount of capital held against compliance and operational risk, and litigation costs, and Deutsche Bank set aside an additional 1.2 billion to meet litigation costs (Finel-Honigman & Sotelino, 2015). Indeed, misconduct is costly from a business perspective because of high litigation and redress costs. The European Systemic Risk Board (European System of Financial Supervision) elaborates in its 2015 report on misconduct risk in the banking sector, on the costs of misconduct. It reports an increase in costs of expanded legal departments, fees for external consultants and legal advisers. The ESRB report refers to a survey that showed 84% of banks reporting an increase in litigation spending since 2008. Finally, redress costs can be a factor in case of mis-selling of financial products. Between 2010 and 2015, more than EUR 100 billion redress costs are paid to both professional and retail clients around the world (ESRB, 2015).

Now, all the costs summed up here – trading losses, fines and settlements, (forced) capital provisions, litigation costs and redress costs – can build up to enormously high ‘costs per case’ that can have a detrimental effect on profitability. The ESRB report (2015) states that without past litigation costs and provisioning for future litigation costs, the total accumulated profits of large European banks in the period between 2010 and 2015, would have been a third higher. Furthermore, uncertainty about often long-lasting litigation may have a negative impact on the shareholder value of banks. The performance of shares of a bank with litigation issues is substantially lower than for banks without litigation issues. The ESRB reports that the market capitalization of the banks with litigation issues would have been EUR 54 billion more in December 2014 if their share prices had followed the same trend as those of the banks without any litigation issues. In sum, the costs of misconduct from a business perspective, have a considerable impact on financial performance. The costs of misconduct can lead to serious capital pressure, forming a risk for soundness and stability of banks.

Business perspective: reputational damage and trust decline

A second detrimental consequence of misconduct in banking, from a business perspective, is reputational damage and its negative impact on trust. Although unethical behaviour in trading businesses does not represent behaviour in the banking sector as a whole, it has likely led to a decrease of trust in our financial economy and the banking system in particular. The current trust of the public, consumers, politicians, companies, in banks is at an ultimate low (Crujisen, van der, *et al.*, 2014; ESRB, 2015). Stereotyping of traders who will do anything to increase their profit, and have lost their heartfelt ambition to serve society, is at an ultimate high. This is alarming because a decrease in trust in the banking sector hurts our real economy. Businesses are more careful to spend and invest. Reputational damage harms future sales and funding conditions, and that is costly. In fact, the ESRB report (2015) states that the “reputational penalty” is estimated to be 7.5 times the total amount of monetary penalties imposed by the U.S. Securities and Exchange Commission on the 585 firms subject to enforcement actions for financial misrepresentation between 1978 and 2002. Reputational damage leads to a decrease in trust, and therefore in a risk for solidity and stability of the banking sector.

Legal perspective

Next to these detrimental consequences of misconduct from a business perspective, negative consequences from a legal perspective are to be considered. Court rulings in misconduct cases increasingly attend to the accountability of the bank involved, and include the senior management overseeing the trader that behaved unethically. Trader misconduct thus implies liability risks for banks and senior management. This was for instance the case for Deutsche Bank, which was ordered in 2013 by a Frankfurt Labour Court to rehire four traders who had previously been fired by the bank, because of their involvement in Libor manipulation². Judge Annika Grey added to her ruling that Deutsche Bank did not have “adequate internal rules and controls in place and did not ensure that rate submitting and derivatives trading was adequately separated”. Here, Deutsche Bank was held accountable for creating circumstances that allowed these traders to behave unethically. Firing them was therefore considered unlawful. Likewise, in 2015 the Financial Conduct Authority fined a former executive of JP Morgan GB£792.000 for failing to be “open and cooperative” about the ‘London Whale’ case (see Table 1)³. This executive oversaw Bruno Iksil, the trader who was linked to the misconduct. Although the fine is not related to lack of oversight or mismanagement in this case, but on his insufficient communication towards financial supervision, it is an example of senior management being held accountable for its role in a misconduct case. A third example of a court ruling that held the bank or senior management accountable is the 2016 ruling in the Kerviel case. A French tribunal ordered Société Générale to pay €400.000 for unfair dismissal, to Jérôme Kerviel, who was sentenced to jail in 2008 (see Table 1)⁴. Kerviel seemingly never denied the fact that he had covered up losses and created fake trades; misconduct that resulted in a trading loss of €4.9 billion. But he also claimed that his employer was fully aware of his actions. The French court ruled that the bank shared responsibility for what happened. Finally, banks are increasingly holding each other accountable for misconduct. An example is the Foundation for Banking Ethics Enforcement (FBEE). This is an independent disciplinary board for bankers, that can issue fines up to € 25.000,- when a banking employee breaches the code of conduct (see: www.tuchtrechtbanken.nl/about-us).

In sum, misconduct has detrimental consequences from a business and legal perspective. Needless to say, taking these consequences in consideration, misconduct by traders within banking needs to be prevented and dealt with effectively. It is not only in the interest of financial supervisors or the general public, but also key to the survival of banks themselves to prevent misconduct from occurring in the future.

² The Telegraph: September 11, 2013. “Deutsche Bank ordered to rehire traders unlawfully sacked in Libor probe”. Available at: <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/10303136/Deutsche-Bank-ordered-to-rehire-traders-unlawfully-sacked-in-Libor-probe.html>

³ The New York Times: February 9, 2015. “Ex-JP Morgan executive fined 1,1 million in London Whale case”. Available at: http://www.nytimes.com/2016/02/10/business/dealbook/ex-jpmorgan-executive-fined-1-1-million-in-london-whale-case.html?_r=0

⁴ The Financial Times: June 7, 2016. “Kerviel wins €400,000 from SocGen for unfair dismissal”. Available at: <http://www.ft.com/intl/cms/s/0/82e3c230-2ca6-11e6-bf8d-26294ad519fc.html#axzz4BrY6cBfS>

