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

Scholten, W.W.

Author: Scholten, Wieke
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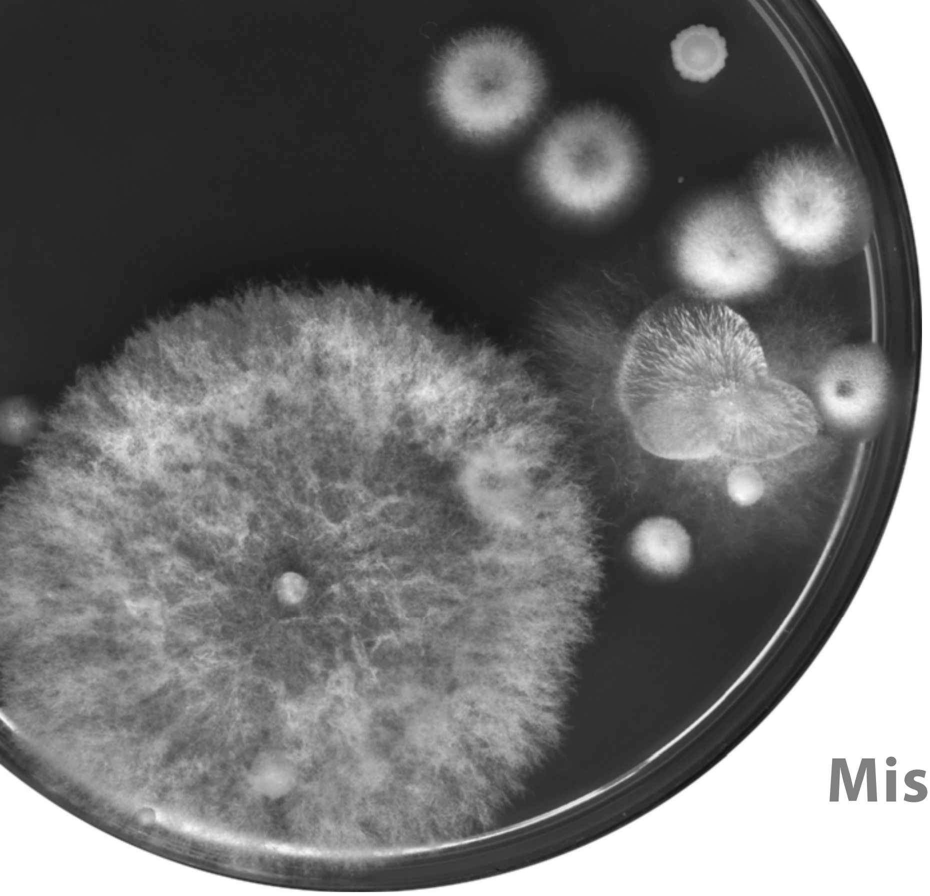

Part I
Misconduct

Chapter 2
Investigating misconduct: conceptualization and context

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1. Conceptualising misconduct

I use the term misconduct to refer to intentional unethical behaviour of traders in banking. Three characteristics are relevant in my conceptualization of misconduct: acts and omissions, intentions and the unethical nature of the behaviour.

Misconduct refers to imputable acts as well as omissions. Acts of traders in this context could be for example sabotage – such as the misrepresentation in financial reports -, bribing others (active corruption) or being bribed (passive corruption) by a third party, theft, the miss-selling of financial products to professional clients or manipulation of financial markets (DNB, 2014). Examples of omissions are: failing to act when action is called for (e.g. warning clients of large financial risks or laying out long term strategy implications) or failing to perform duties or responsibilities (such as reporting information on deals, or specifying transaction costs). In lay terms these acts and omissions are referred to as 'fraud'.

Misconduct refers to intentional behaviour. This means that unintended errors and accidents are excluded from this analysis. Intentional behaviour means that there is an explicit intention, a will, an aim, that motivates the involved trader or sales professional to act or not act (in case of an omission) in ways that imply professional misconduct. The exact intentions for misconduct often cannot be established in retrospect. In fact, they often are not even explicitly addressed in reports on misconduct cases by banks (as a result of internal investigation by audit or legal departments for instance) or by financial supervision. These reports tend to take a legal perspective as they focus on the facts of misconduct, the (financial) impact and causes in terms of opportunity to behave unethically, the lack of oversight and the failure of control mechanisms. The individual intentions that may have led to the misconduct are often not investigated or at least not reported. However, it is often presumed, by public, media and the banking sector itself, that such intentions are obvious. For instance, traders are seen to exceeded risk limits because they wanted to make high revenue to ensure their bonus. Their motivation for (not) acting thus is assumed to consist of the desire for individual monetary gain. The contextual causes of this behaviour – such as the social norms within a team on how to deal with these risk limits - are disregarded. This is in line with the fundamental attribution error (Ross, 1977), explaining people's tendency to infer intentions when observing others behave, whilst disregarding contextual causes that led up to this behaviour. However, when analysing one's own behaviour, these contextual causes or circumstances are weighed heavily.

- *An illustrative example from supervisory practice (Nr. 1, see Table 2.1)*

  "*These guys want to rob my bank*", uttered a CEO of a global significant bank during a discussion of misconduct cases within his investment banking division. With 'these guys' this CEO referred to the traders who were involved in the misconduct cases that were subject of this supervisory meeting with him. He implied that the traders that behaved unethically, were motivated by the desire to gain money and steal this from the bank.

Another inferred intention – also driven by the alleged desire for individual gain - is that a trader wants to increase promotion chances and therefore aims at impressing his or her superiors with his or her trading strategies. Also, the desire to cover up losses as a way to maintain a certain status within his or her team is related to the inferred desire to increase monetary outcomes or organizational prospects. The interview with Adoboli cited at the introduction of this book, suggests this may have played a role in his case. Again, these individual intentions are not studied systematically and could be interlinked or be different expressions of the same motive. Even though misconduct in this analysis is used to refer to intentional behaviour, I do not aim to identify a single explanatory intention – along the lines as mentioned above. Even though I conceptualize misconduct as a form of intentional behaviour, the specific underlying individual motivations of the traders involved are not the focus of my analysis. The focus of my analysis is to assess the drivers in the social context of these traders, as raising intentions that influenced their individual misconduct.

Misconduct refers to unethical behaviour, that is, behaviour that breaches widespread agreement about what is right and wrong. Kish-Gephart, Harrison and Klebe Treviňo (2010) define unethical behaviour in a work context, as organizational member actions that violate widely accepted (societal) moral norms. This definition aligns with other research on ethical behaviour in work contexts (Kaptein, 2008; Treviňo & Nelson, 2007). According to Kish- Gephart *et al.* employee behaviours that breach generally accepted moral norms of behaviour include lying to customers, theft, sabotage and misrepresentation in financial reports. They exclude other negative workplace behaviours such as lateness from this definition, because these may not be intentional and do not necessarily violate widely accepted societal moral norms (Kish-Gephart *et al.*, 2010).

Misconduct refers to unethical behaviour, that can also be illegal. Illegal behaviour is behaviour that breaches legal regulation or rules. In the trading and sales context, financial and trade sanctions and regulation governing competitiveness (collusion of market prices) are examples of these regulations. Bear in mind that, although unethical and illegal behaviours overlap, there are also unethical behaviours that are not illegal, such as behaviours that are 'only' prohibited by codes of conduct. Trevino and Nelson (2007) use the 'financial meltdown of 2008' to explain the difference between unethical and illegal behaviour. They claim that the implosion of the financial market in 2008 was a result of unethical behaviour, not of behaviour that was illegal at the time. "Government regulators and the legal system often play catch-up after unethical debacle in business": the activities that brought down the economy were not (yet) illegal. However, they state, many of those activities were seen as unethical and were contrary to ethical principles such as responsibility, transparency and fairness.

In sum, in my analysis I consider misconduct as referring to unethical behaviour, that can be illegal as well. As discussed later on, misconduct cases in the financial context are often handled by legal departments, focusing on a legal approach. In this approach, the misconduct considered is often confined to mere illegal conduct. The present research chooses a broader approach of misconduct that focuses on the unethical nature of behaviour displayed by traders in these cases. It adds to the dominant legal paradigm within banking, when dealing with misconduct, as will be elaborated in Chapter 3. This conception of misconduct also clarifies that regulatory developments, adding rules and restrictions, cannot fully control unethical behaviour by itself – rules alone are not enough to prevent future problems. Next to rules, culture improvements are needed. The aim of my analysis and research is to reveal levers that can help improve team climates and with that, prevent future misconduct.

2. Clarifying the context: supervision of behaviour and culture

I examine the validity of the analysis provided, with a detailed consideration of misconduct cases and anonymous examples derived from information gathered in the context of actual supervisory activities. Although the examples are based on real practices and actual communications, the anonymity of the supervised banks is guaranteed and the supervisory information remains confidential. The materials used for this purpose consist of supervisory information, comments and events that I observed at Dutch and European banks – including significant institutions ('too big to fail' banks), during my work as a senior supervisory officer of behaviour and culture at De Nederlandsche Bank (DNB).

DNB is responsible for prudential supervision of financial institutions, including banks, in the Netherlands. Since 2011, in addition to addressing solvency and liquidity of financial institutions, the DNB supervision also takes into account behavioural patterns and culture aspects of these institutions (Raaijmakers, 2015; Nuijts & De Haan, 2013). Behaviour and culture supervision observes and analyses behavioural patterns in, for instance, leadership, decision making and group dynamics that are essential for sound functioning and enduring performance of a bank. The aim of this type of supervision is to identify and mitigate the risks these behavioural patterns or cultural aspects can have for financial stability and performance of a bank. For example, a trading team handling errors in such a manner that a bank does not learn from what happened, nor is able to prevent the same error from happening again – resulting in ineffective error management – is an example of a behavioural pattern that bears risks for the enduring financial stability of the organization.

DNB was globally the first financial supervisor that explicitly extended supervision to the domain of behaviour and culture (Raaijmakers, 2015; IMF Global Stability Report, 2014). An expert team of supervisors with different professional backgrounds, including organizational psychologists, executes this supervision and is also required to deliver expertise to European banking supervision. More financial supervisors, such as the Dutch Authority for the Financial Markets (AFM) and the Australian Prudential Regulation Authority (APRA) are now working with supervisory expert teams that are explicitly dedicated to behaviour and culture.

The information provided about concrete cases is derived from supervisory assessments at Dutch and European banks, including the 'too big to fail' banks. Every example included in this research is anonymized and stems from interviews conducted in the context of behaviour and culture supervision. The records of these interviews are kept by DNB supervision. Table 2.1 lists the 17 illustrative supervisory examples used throughout this book, and offers information about their sources. These stem from interviews with 14 key players at 4 different banks. The supervisory meetings are conducted primarily with traders within investment banking divisions, executive (management) board members responsible for these businesses, and compliance, audit and risk management officers. By implication, the anonymous examples and cases used here are representative for the Dutch and European banking sector, and reflect real practices within these banks.

Table 2.1. *Sources of illustrative supervisory examples in this book*

Nr.	Page	Snippet from illustrative example	Interviewee	Role	Bank
1	30 and 44 (used twice)	*"These guys want to rob my bank"*	1	CEO	Bank A
2	35	*"We are risk managers, more than traders".*	2	Senior trader	Bank A
3	37	*"They were hiring us by the dozen"*	2	Trader	Bank A
4	37	*"You do fx, you do fx, and you do fx, And who gets the business set up first, gets to run it."*	3	Senior manager of trading desks	Bank A
5	38	*The only thing that counts is our P&L: profit'*	4	Trader	Bank A
6	44	It was a set up: the trader and the third party arranged this scheme before the trader started to work at this bank.	-- (derived from desk research)	-- Not a quote	Bank A
7	45 and 100 (used twice)	*"That is just the way he is".*	5	CEO	Bank C
8	50	*"I know something happened at the desk two rows away from me on the floor, since someone was suddenly missing and fired"*	6	Trader	Bank A
9	50	"*Tell me their names, and I will fire them all* ",	1	CEO	Bank A
10	51	Instead of their own cases, anonymized cases of other banks were used as illustrative training material.	7	Senior compliance officer	Bank A
11	54	"*Culture or profit: what do they want from me* ?"	8	Trader	Bank A
12	97	*"We assume you have thought this over. Please explain to us your reasoning on these events"*	9	Senior manager (CEO-1)	Bank B
13	98	The colleague confirmed that the reputation of the employee was damaged, although the blame of the failed project on the employee stayed implicit.	10	A project leader and colleague	Bank D
14	101	In strong words – including swearing - he was summoned up to the board floor. The senior manager dreaded these calls and what would come next.	9	Senior manager (CEO-1)	Bank B
15	106	*"Stop preaching to me, with your income you do not need to worry about making more money like I do"*	12	Trading desk head	Bank A
16	107	"*He made us look like we were criminals! I never have been so angry"*	11	Trading desk head	Bank B
17	110	*"It is kind of strange isn't it… I work in oil, but I personally do not think it is good for our climate and environment"* .	13	Middle manager of trading desks	Bank B
18	146	The senior manager calling the desk head of desk A, with the dysfunctional leadership style, "high potential" that needed some coaching to work on his "relationship management".	14	Senior manager of trading desks	Bank B

In Chapter 9, I present an assessment framework that is used by the DNB supervision of behaviour and culture in the Dutch and European context. It is designed to identify and assess social psychological root causes of misconduct within trading teams. This assessment has the aim to mitigate misconduct risk by requiring banks and businesses within banks to change team climates that harbour these root causes. The empirical evidence described in Part III of my analysis is the outcome of the application of this framework by the DNB supervision of behaviour and culture.

3. Clarifying the context: trading

For my analysis, I chose to focus on the context of trading businesses within (investment) banking. In this section I substantiate this choice of context, and elaborate on the organizational aspects that characterize this professional context. Misconduct occurs within the financial sector mostly within banking. De Nederlandsche Bank (DNB) – the Dutch central bank and financial supervisor of the Netherlands – registers supervisory incidents, among which misconduct cases. DNB oversees the Dutch financial sector and distinguishes within this sector between four subsectors: banks, insurance companies, pension funds and trust agencies.

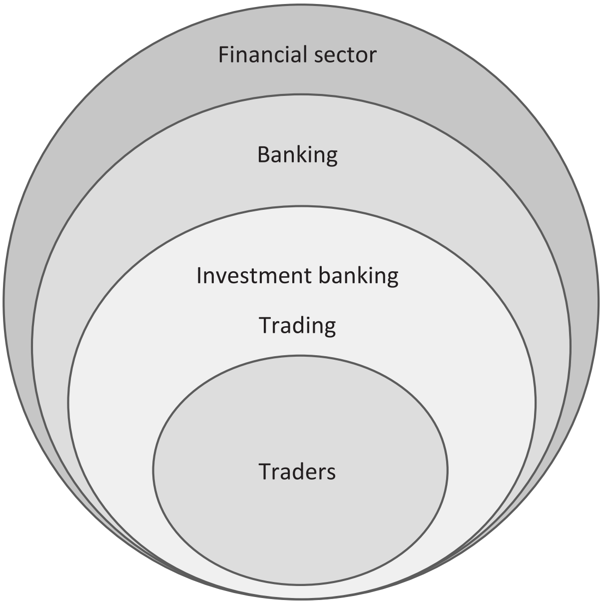
Table 2.2. *DNB Supervisory Incidents – 2013, 2014, 2015*

DNB supervisory incidents				
	Banks	Insurance companies	Pension funds	Trust companies
The total number of misconduct cases (or 'integrity incidents'), added over the three years 2013, 2014 and 2015	30	17	7	6

The DNB data shows (see Table 2.2) that in the Netherlands, most known misconduct cases occur in the banking sector, opposed to the other subsectors. This is not just the case for the Netherlands: also at international level, banks are the financial institutions facing the most significant misconduct issues (ESRB, 2015).

My analysis reported here specifically addresses unethical behaviour of traders, who work in trading business, within investment banking. For simplicity and readability, I refer in this analysis to these professionals as 'traders'. Figure 1.1 shows how banking, relates to investment banking, and to the businesses central in my analysis. Boxes 2 and 3 summarize what investment banking and trading businesses entail.

Figure 2.1. Zooming in: the context of this research.



I chose this specific context for misconduct – the trading business - for two main reasons. First, the risk and impact of misconduct occurring in trading is relatively high. Traders often have control of large amounts of funding or credit. A large part of profit of a bank is made here. Traders are highly responsible for decisions they make and often have to make these decisions by themselves, under time pressure (for instance when traders run their own book). Hedging the risks that come forth from trading positions, is one of the most important tasks of a trader. A senior trader remarked during a supervisory interview in 2015: "*We are risk managers, more than traders" (Nr. 2, see Table 2.1)*. In sum, unethical behaviour of traders, can lead to severe financial consequences for the bank (see for instance the trading losses in Table 1.1).

Box 2. Trading business

Trading businesses generally deal with four main asset classes: rates, equity (stocks), cash equivalents (money market instruments) and fixed income (bonds). For example, the markets division within Corporate Banking & Securities of Deutsche Bank AG (Deutsche) was at year-end 2013 responsible for trading of fixed income, equity, equity-linked, foreign exchange and commodity instruments, in addition to structuring and implementation of financial risk management solutions for institutional clients (Finel-Honigman & Sotelino, 2015). The main trading locations in the world are London ('the City'), New York ('Wall street') and Singapore/ Sydney.

Box 3. Investment banking

Investment banking refers to capital markets services of banks to institutional clients. According to Finel-Honigman and Sotelino (2015), 'the primary role of an investment bank is to design and realize financing structures, that satisfy the objectives and constraints of both the issuers and investors'. Investment banking is often combined with corporate banking within a wholesale bank. The main revenue generating activities of an investment bank encompass (Finel-Honigman & Sotelino, 2015) securities underwriting, secondary market-making in these securities for investors, structuring of, and market-making for risk management instruments (derivatives), propriety trading in securities, commodities, foreign exchange and derivatives, credit (typically short-term and secured) to issuers, investors and trading counterparts and mergers & acquisitions advisory services.

A second reason to focus this research on misconduct within trading businesses, is that many examples of misconduct that are known to the public occurred in these businesses. The examples given in Table 1.1 are illustrative of that. Misconduct of traders has received media exposure and therefore has impaired the trust of the public in the soundness and integrity of banking in general.

Even though the context of my analysis is rather specific, as illustrated in Figure 1.1, misconduct can take place at any organizational context or specific business. It can display itself at a level across businesses, a whole bank or across the entire banking sector. In principle, the Corrupting Barrels model that I develop and the supervisory framework that is a result of my analysis can be used in any organizational context.

Organizational aspects

There are three organizational aspects that I will discuss here, since they characterize the professional context of (investment) banking and trading businesses specifically. These are aspects of the organizational context, that are relevant for behavioural patterns and team climate within trading teams. These three organizational aspects are: a history of strong and fast growth of the businesses, a history of revenue as the main organizational goal, and a history of high pay or incentive compensation.

First, investment banking has a history of strong and fast growing business. The 1990's pushed trading businesses to great heights. Due to the lowering of barriers to international capital flows, rapid technological change and the explosive growth of securities markets, many corporate commercial lenders engaged in investment banking in this period of time. Banks would buy investment banking activities, and rapidly set these up themselves (Finel-Honigman & Sotelino, 2015; Brink, R.C.G. van der, 2003).

- *An illustrative example from supervisory practice (Nr. 3, see Table 2.1)*

  During interviews with traders of a global significant bank during a supervisory assessment, a trader looked back on how he was hired in the early 2000's. He stated 'They were hiring us by the dozen', and remembered how he was sitting in a hallway with 'twenty other guys who went for trading positions'. 'They were calling us in two at a time, running different interviews simultaneously'.

This simultaneous hiring of traders and whole trading teams, came hand in hand with a push on growing the business rapidly.

- *An illustrative example from supervisory practice (Nr. 4, see Table 2.1)*

  During a supervisory interview at a global significant bank, a senior manager within investment banking who worked as a trader at that same bank in the early 2000's recalled how the Fx trading business was set up and started. She recalled that many Fx traders were hired at the same time and were instructed as followed: '*You do Fx, you do fx, and you do fx. And who gets the business set up first, gets to run it*'.

There are two risks of this legacy of strong and fast growth in trading businesses and teams. First, the fast acquisition and building of investment bank activities by retail or consumer banks led to a degree of *detachment* of these investment banking activities from the bank. These investment banking activities were often unknown territory for these banks: new products, a new way of making money, new geographical locations and a new kind of people (Van der Brink, 2003). This detachment of the organization as a whole, led to a high autonomy of these trading businesses. It contributed to the creation of an isolated playing field with the possibility to set up own rules and new ways of working.

Second, all banks were acquiring or setting up investment banking activities during the same period (roughly 1989 – 2008: see, Finel-Honigman & Sotelino, 2015; Van der Brink, 2003). This led to a high demand for young traders, and resulted in considerable mobility: being a 25 year old Fx trader, in those days you could find highly paid employment at many banks. If a position did not suit you, there was plenty of opportunity to 'hop' to another Fx team, at another bank (even often in the same financial district, e.g. around the corner). Both aspects, detachment of the organization leading to autonomous playing fields and high employment mobility, would make it easier for young Fx traders to identify and connect with their peer group – Fx colleagues - rather than the particular bank they were working at. The detachment, autonomy and mobility evoked identification with teams, over and above identification with the organization as a whole.

Now, why is this high identification with a team relevant for the contextual root causes of misconduct? The more we identify with our team, the more our team influences our individual behaviour (Postmes & Branscombe, 2010; Ellemers et al, 1999; Tajfel & Turner, 1979). A high identification with a trading team augments the influence of that team – and its distinctive norms and habits - on the ethical behaviour of an individual trader. Therefore, a legacy of fast growth of the business is a contextual factor that possibly strengthens the relation between root causes at the team level and misconduct.

A second relevant contextual factor for investment banking is the legacy of revenue being the main organizational goal. In my supervisory interviews with traders, increasing profitability was often seen as the main goal of their work, and the main thing management asks of them.

- *An illustrative example from supervisory practice (Nr. 5, see Table 2.1)*

  During interviews with traders of a global significant bank during a supervisory assessment, a trader talked about the messages he got from his management. He stated '*The only thing management communicated were the numbers: how well did we do these months. That was it. The only thing that counts is our P&L: profit*'.

This management push on revenue leads traders to perceive that the goal of making financial profit (the 'what'), is more important than the way to make this profit (the 'how'). In the period of fast expanding businesses, the instruction was to get there quickly ("*And who gets the business set up first, gets to run it", Nr. 4, see Table 2.1*), but there was little leadership on how to get there.

The push on profit was strengthened by the incentive compensation system that was common in these banking divisions. This is a third relevant aspect in the legacy of trading businesses: the high proportion of variable (vs. fixed) pay, that was connected to revenue. The more profit you made as a trader, the more you got paid. It is not hard to see that this single focus on profit has an undermining effect on ethical behaviour. If making as much profit as you can is the only goal of importance, this provokes people to transcend ethical boundaries. In the perception of traders, profit and ethics could be contradictory. An example from supervisory practice of the trader that stated "*Culture or profit: what do they want from me*" (Nr. 11, see Table 2.1), illustrates this. Also, the quote of Adoboli at the start of this book suggests this perception: "*others did in fact know, and actively encouraged his behaviour for more than two years as long as it was profitable*". So, the push on profit evokes unethical behaviour by itself. And, although the banking industry acknowledges that misconduct can relate to a motivation of individual gain, it disregards the link between this motivation to gain individually and the organizational context and culture. The motivation to gain, causing a trader to behave unethically, is seen as an individual motivation and not as a result of a social context that values profit as a measure of success.

Moreover, since the 'how' to make profit is not addressed in interpersonal communications, neither is part of management instructions nor reflected in the targets that variable compensation is based on, the moral dimension of trading remains implicit. So, next to evoking unethical behaviour by itself, the push on profit results in a blind spot for the 'how' to make profit. This blind spot augments the development of a team climate of moral neglect, that is a contextual root cause for misconduct.

In sum, my choice to analyse contextual root causes of unethical behaviour within trading, is based on an increased risk of misconduct in the trading and markets business. As discussed, the legacy of fast expanding businesses and a push for revenue strengthened by a habit to incentivise financial performance with (high) variable compensation, creates an environment where transactions are likely to be valued over and above ethical considerations. Together with the size of transactions common in investment banking (compared to for instance the retail business of a bank), and the legacy of publically known misconduct cases leading to considerable losses and regulatory fines, I argue that trading within investment banking is a context that requires an effective approach to prevent misconduct. Furthermore, I argue that insight in team climate characteristics that can facilitate unethical behaviour adds value to preventive approaches that can be applied in a broader variety of organizational contexts. I therefore chose to focus my analysis on team climates at trading desks.