



CASS
BUSINESS SCHOOL
CITY UNIVERSITY OF LONDON
EST 1894

Changing more than a name

The CBR Conduct Costs Project

[Centre for Banking Research (CBR)]

CENTRE FOR BANKING RESEARCH (CBR)

The Centre for Banking Research (CBR) promotes topical and high calibre academic research in banking. Founded in 2008, CBR is building upon a long history of banking research at the Business School (formerly Cass), City, University of London. Our mission is inspired by the vision of the founder, the late Professor Shelagh Heffernan, who believed in the importance of connecting academic researchers with practitioners and policymakers. The need for on-going dialogue and evidence-based policy decisions is of the utmost importance, in the context of fast-changing technology and innovation impacting the banking industry. Our mission is to disseminate cutting-edge research and engage with a wide array of stakeholders, leveraging our network of excellence in banking research through publications, workshops, and events.



THE EURO-MEDITERRANEAN ECONOMISTS ASSOCIATION (EMEA)

The Euro-Mediterranean Economists Association (EMEA) is a Barcelona-based regional think-tank established in 2012 that serves as a leading independent and innovative policy research institution that bridges between Europe; the Mediterranean and Africa, a forum for debate on the political and socio-economic reforms in Mediterranean and Africa; and promoter and co-funder of actions and initiatives that fulfill objectives of sustainability, inclusiveness, regional integration and prosperity. It strives to contribute to the rethinking of the Euro-Mediterranean and Africa partnerships in view of the new dynamics of an emerging multi-polar world and amidst of protracted crises. EMEA has a large network of economists, high-level experts and institutional partners (research institutes, think tanks and universities) in the Euro-Mediterranean and Africa. EMEA builds on the collaborative research network Mediterranean Prospects (MEDPRO) (funded by the EU's Seventh Framework Programme (2009-13) and provides forward-looking thinking and political and socio-economic integrated analyses on the Euro-Mediterranean region. EMEA is also the promoter and co-funder of the Euro-Mediterranean Network for Economic Studies (EMNES), co-funded by the European Union between 2015 and 2019. EMNES is a regional network composed of 30 institutions and more than 100 experts and researchers in the Mediterranean region.

EMEA has co-sponsored this project.

Copyright © 2020 City, University of London. All rights reserved. No part of the materials available in the Centre for Banking Research (CBR) Conduct Costs Project report. may be copied, photocopied, reproduced, translated or reduced to any electronic medium or machine-readable form, in whole or in part, without the prior written consent of City, University of London. Any other reproduction in any form without the permission of City, University of London is prohibited. Distribution for commercial purposes is prohibited.

Written requests for permission should be sent to Clare.Avery@cass.city.ac.uk

Contents

Centre for Banking Research
The Business School (formerly Cass)
T: 020 7040 5230
E: bankingcentre@city.ac.uk
www.cass.city.ac.uk/cbr

Summary	2
Background	3
Benchmarking conduct costs	3
The CBR Conduct Costs Project key indicators	4
The definition of conduct costs	5
A global systemic risk	6
International results table: periods 2013 – 2017 and 2014 – 2018	8
Project's metrics (2008 – 2018)	10
Cause codes	10
Cost codes	12
Culpability codes	13
Limitations	15
Drivers for progress	16
Conclusion and next steps	17
Appendix I: Glossary	18
Appendix II: Cause codes, Cost codes and Culpability codes	19
Charts	
Figure 1. Conduct costs for the 20 banks (GBP Bn)	5
Figure 2. Conduct costs by geographical area (GBP Bn)	6
Figure 3. Cumulative conduct costs for the 20 banks, from 2008 to 2018 (GBP Bn)	6
Figure 4. Conduct costs to GDP ratio	7
Figure 5. Conduct costs and provisions, by period (GBP Bn)	9
Figure 6. Comparative trends of the conduct costs, for the 20 Banks (GBP Bn)	9
Figure 7. Conduct costs, Cause code (GBP Bn)	10
Figure 8. Cause codes by geographical area (GBP Bn)	10
Figure 9. Cause codes, from 2008 – 2018 (GBP Bn)	11
Figure 10. Conduct costs for the years 2008 – 2018, across all twenty banks, split by Cost codes (GBP Bn)	12
Figure 11. Cost codes by geographical area (GBP Bn)	12
Figure 12. Conduct costs, Culpability codes (GBP Bn)	13
Figure 13. Culpability codes by bank (GBP Bn)	14
Table	
Table 1. International results table: periods 2013 – 2017 and 2014 – 2018 (GBP Bn)	8

Summary

Banks' conduct costs in the post-crisis era continue to be a matter for concern, and they remain even more relevant in the current Covid-19 crisis, as they indicate how successful banks have been in restructuring their culture, articulating the desired culture, and maintaining their cultural vision.

The CBR Conduct Costs Project aims to foster transparency in financial activity and to deliver a category of benchmarking, which comprises the level of conduct costs and the conduct risk of the banks, as an analytical tool for the banks and their stakeholders. The Project also provides valuable insight into banks' culture, conduct, competence, and regulatory risks. We argue that the use of clear and publicly available metrics for banks' conduct costs is an important step forward to ensure the trustworthiness of the banking sector, and it is paramount to foster an ethical culture in financial firms.

This report discusses the financial consequences of bank misconduct for twenty of the world's leading banks, from January 2008 to December 2018.

“The story of financial market crisis since 2007 falls, essentially, into two parts: The first was the Financial Crisis of 2008 – 2009. The second, albeit of arguably no less significance, was a crisis of conduct.”¹

McCormick, R. and Stears, C., “Legal and conduct Risk in the Financial Markets”

“In recent years, the incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets.”²

Carney, M., “Building a Resilient and Open Global Financial System to Support Sustainable Cross-Border Investment”

“The use of Conduct Costs is a metric for not only conduct risk management purposes – but also as a proxy for how ‘ethically healthy’ a bank is and as an indicator of a firm’s culture and trustworthiness.”³

McCormick, R. and Stears, C., “Legal and conduct Risk in the Financial Markets”

1. McCormick, R. and Stears, C., “Legal and conduct Risk in the Financial Markets”, 3rd edition, Oxford University Press, 2018.

2. Carney, M., “Building a Resilient and Open Global Financial System to Support Sustainable Cross-Border Investment”, Financial Stability Board, August 30 2016..

3. McCormick, R. and Stears, C., “Legal and conduct Risk in the Financial Markets”, 3rd edition, Oxford University Press, 2018.

Background

“Conduct risk is driven by not only the banks’ business models and their decision-making processes but may also reflect the underlying culture.”

The Conduct Costs Project started at the London School of Economics in 2012 and, in 2014, migrated to the CCP Research Foundation.⁴ It was during these years that the bank conduct crisis started to become a serious concern for regulators, who were not only focused on bank resilience and capital adequacy but also conduct. Conduct became increasingly important also for the banks themselves, as they were trying to reassure customers and investors that misconduct episodes were legacy issues and were looking to regain trust. And bank conduct became increasingly relevant for stakeholders who demanded accountability.

From 2013 to 2017, the Conduct Costs Project published its research for twenty leading banks on a five-year “rolling” basis and presented information in a comprehensive format for “conduct performance.” It provided data on various categories of problems, jurisdictions, as well as year-by-year (from 1 January 2008 up to 31 December 2016), and was a key enabler of comparative research. The Project’s findings have been acknowledged and referred to several times by a wide range of stakeholders, from media, at conferences, specialised journals in banking, financial market issues, consultancies, regulators, and by the Bank of England.

In May 2019, the Project transferred to the Centre for Banking Research at the Business School (formerly Cass), City, University of London, which will continue the research and its publication.⁵

CONDUCT RISK

Banks play an essential role in the global economy and society. It is equally important that they play a positive one. The impact of conduct costs in the context of banks’ profitability and conduct risk management affects their reputation. Yet, the banks’ publication of a code of ethics or code of conduct does not protect their reputation or regain stakeholders’ trust by itself.

Since the global financial crisis banks have settled conduct costs, describing them as “legacy issues” and claiming that those problems were behind them, only to see new cases emerge again, leading to costly settlements with regulators. Banks’ misconduct continues to be a matter for concern as it represents a financial and reputational threat to financial institutions. Conduct costs are also evidence of harm suffered by those who deal with banks and can ultimately threaten financial stability and erode trust in the financial sector.

BENCHMARKING CONDUCT COSTS

As a key tool for assessing conduct and culture, the benchmarking of conduct costs provides benefits to the banks and their stakeholders, beyond those associated with transparency and reputation. The main arguments for benchmarking the banks’ conduct costs against their peers, identifying leaders and laggards, in line with conduct costs trends, are:

- **Transparency:** Benchmarking of conduct costs would lead to better monitoring of financial institutions and their managers by their shareholders

and stakeholders (i.e., customers, counterparties, investors, employees, governmental authorities). The quality of a bank’s disclosures of conduct performance, for example, is of relevance to questions of risk management and accountability and also influential to a banks’ culture.

- **Ethics:** Benchmarking of conduct costs would improve general awareness of banks’ conduct, stated values, and “ethics-led” decision-making landscape of financial institutions.
- **Governance:** Benchmarking of conduct costs would be an instrument of “cultural” performance, acknowledging each bank’s commitment to managing resources, competence, and internal controls conscientiously and effectively.
- **Conduct Risk:** It is of crucial importance for the management of conduct risk to have access to a quantitative indicator of the bank’s risk performance, to complement qualitative judgments over conduct performance. A quantitative indicator can also be integrated as a warning system to signal further analysis process.
- **Culture:** Benchmarking of conduct costs would become an indicator of the effectiveness of the industry’s efforts in building robust risk management and strong ethical culture, as well as preventing misconduct in financial institutions.

4. CCP Research Foundation, CIC was an independent social enterprise vehicle, set up to foster and support a new generation of research projects on the theme of “Conduct, Culture and People”. (2014-2020)

5. Some members of the Conduct Costs Project’s original team are continuing to be closely involved in the project.

The CBR Conduct Costs Project key indicators

The CBR Conduct Costs Project is the outcome of a continuous process of research, providing analysis and insights on the level of conduct costs that have been imposed on global banks since the global financial crisis.

The project owns a unique dataset, with reliable, comparable, and relevant information, underpinned by data available in the public domain and without a minimum threshold of conduct costs.⁶ Each event that meets the criteria of the conduct costs definition is recorded against multiple fields (e.g., date of crystallisation, originating jurisdiction, prosecutorial authority, and additional coding).⁷ The events include fines, judgments, and settlements against the bank. Conduct costs might also include disgorgement of profits, the costs of repurchasing securities at par, and private actions that relate to misconduct. The comparative nature of the project's data presents the opportunity to benchmark a bank's risk profile, its conduct risk management, culture, and potentially, its regulatory requirements.

With the objective of tracking conduct costs from cause to consequence, a cause code, a cost code, and a culpability code are assigned to each event. These codes clarify, quantitatively, the circumstances and consequences of the misconduct giving rise to the conduct cost.

CAUSE CODE

Relating to a conduct cost, a Cause code reflects a broad range of events, from mis-selling claims to market abuse and market manipulation, sanctions 'violations, money-laundering related issues, defective internal controls and failure to disclose as required by law and others.

COST CODE

A Cost code referring to the conduct cost indicates whether misconduct resulted in i) a fine or penalty, ii) a cost arising out of regulatory directed redress, or iii) some other liability.

CULPABILITY CODE

A Culpability code reflects different levels of responsibility and moral culpability, thus indicating that not all conduct problems are the same. This report identifies seven categories, which reflect the egregious nature and severity of the conduct. These categories are ranked in descending order of bank culpability, that is, from corporate and individual criminal conduct to regulatory and behavioural transgressions.

The analysis of the Cause codes, along with the Cost and Culpability codes, are presented in the Projects' metrics section. The definitions of the cause, cost, and culpability codes are provided in Appendix II.

6. The data is in the public domain: we consider regulatory enforcement and reports from different jurisdictions; private dispute settlement and court orders; Banks' Annual Report and Accounts and Sustainability Reports; Media Reports. The absence of a minimum threshold allows us to include all episodes of misconduct. The data is continually subject of identification and verification as further (and/ or better) information is available in the public domain.

7. The complete definition of conduct costs is provided in in Appendix I.

The definition of conduct costs

The definition of conduct costs ought to capture behaviour that impugns the integrity and good standing of the bank, on an objective basis. The scope of the definition is not limited to materiality, as all instances of misconduct should be taken into account.

This project incorporates and refines the working definition of conduct cost developed by the CCP Research Foundation. The full definition is available in Appendix I.

Conduct costs are ‘attached’ to the date on which a liability ‘crystallises’ (by judgement, settlement, or award). There is, however, a time lag factor on the conduct costs.⁸ Also, and to present the fullest account possible of a bank’s conduct costs (and risk) over one determined period, the project records the bank’s provisions (and contingent liabilities) for the final year.

“\$150 billions of fines levied on global banks translates into more than \$3 trillion of reduced lending capacity to the real economy.”

Mark Carney

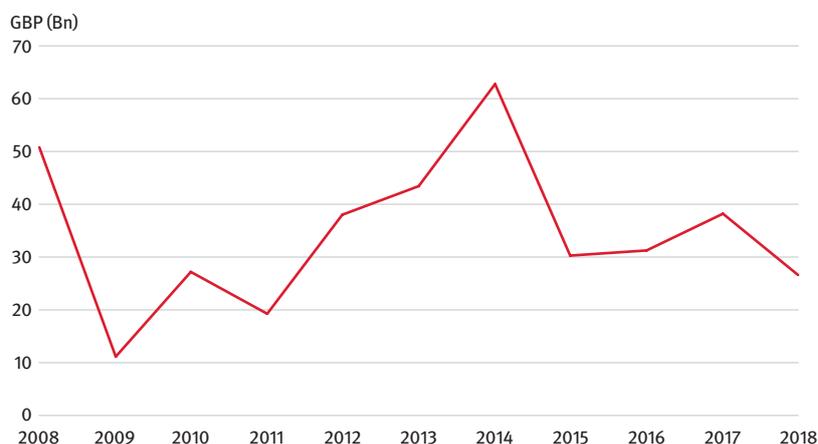
FINDINGS AND RESULTS

In aggregate, between January 2008 and December 2018, the 20 international banks, included in our analysis, have paid conduct costs in excess of GBP 377 billion.⁹

By 2014, 93.4% of the total conduct costs were incurred by banks with a global systemically important bank classification (G-SIB). By 2018, G-SIB banks still accounted for 89.1% of the total of conduct costs, thus highlighting the importance of continuing to monitor these entities and their conduct, as part of safeguarding the stability of the global economy.

In his speech given at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London in 2015, Mark Carney, then Governor of the Bank of England, noted that “\$150 billions of fines levied on global banks translates into more than \$3 trillion of reduced lending capacity to the real economy.”¹⁰ These amounts emphasise the systemic nature of this industry-wide phenomenon. Undoubtedly, conduct risk can impact financial institutions as a whole, as well as financial markets and the global economy.

Figure 1: CONDUCT COSTS FOR THE 20 BANKS (GBP Bn).



8. Events are only taken into account when they have “crystallised” (e.g. a judgement has been given, a settlement agreed, or a provision made in accounts). This can affect the timing of inclusion of figures in the tables. For example, the cost of remediation by repurchase appears in the year the settlement was reached, even though the bank concerned may take several years to repurchase the financial instruments from customers.

9. The banks included in this study are: Bank of America Corporation, Barclays, BNP Paribas, Commerzbank AG, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs Group, HSBC, ING Group, JP Morgan & Chase, Lloyds Banking Group, Morgan Stanley, National Australia Bank Group, The Royal Bank of Scotland, Santander, Société Générale, Standard Chartered, UBS and Wells Fargo & Company.

10. Carney, M., “Building real markets for the good of the people”, Speech given at the Lord Mayor’s Banquet for Bankers and Merchants of the City of London at the Mansion house, London, 2015.

A global systemic risk

In the aftermath of the global financial crisis of 2008, US banks accounted for the vast majority of the reported conduct costs (87.22% in 2010).¹¹ Since 2012, however, the UK and Euro Area banks' costs have increased, reducing the US banks' weight to only 20.50% in 2018 (Figure 2). Whether this shift is driven by improved behaviour of US institutions or reflects the increased scrutiny by European regulatory entities is still to be understood.

Over the past ten years, the cumulative total of conduct costs amounts to GBP 205.25 billion for the US banks in our sample; GBP 86.09 billion for the UK banks; GBP 41.31 billion for the Euro Area banks; GBP 40.19 billion for the Swiss banks, and GBP 4.62 for the Australian bank. Overall, the cumulative conduct costs reveal global vulnerabilities across different markets and jurisdictions (Figure 3).

Misconduct not only undermines confidence in financial institutions and markets, but it may also impact other sectors and society at large. It might be linked to poor corporate governance, such as flawed remuneration policies and incentive schemes. The impact of misconduct can be wide-reaching, translating into job /employment cuts and inferior payment of dividends to shareholders.

Figure 2: CONDUCT COSTS BY GEOGRAPHICAL AREA (GBP Bn)

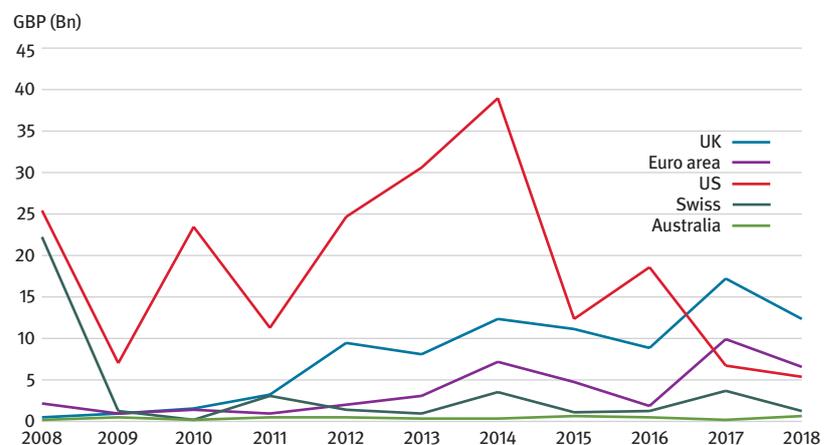
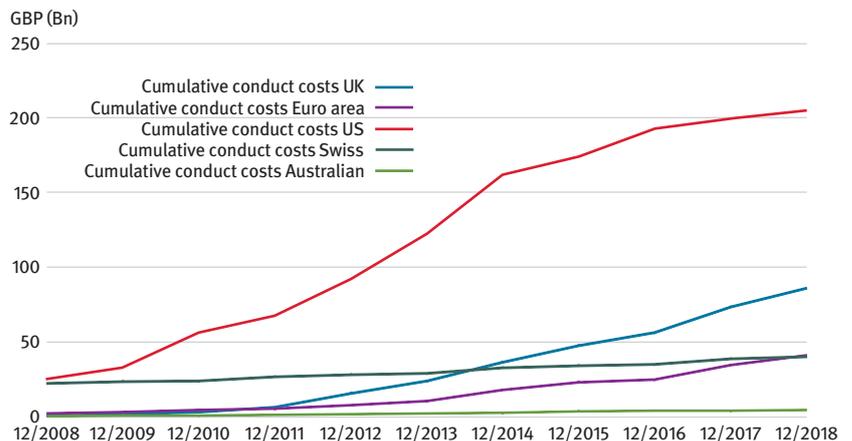


Figure 3: CUMULATIVE CONDUCT COSTS FOR THE 20 BANKS, FROM 2008 TO 2018 (GBP Bn)



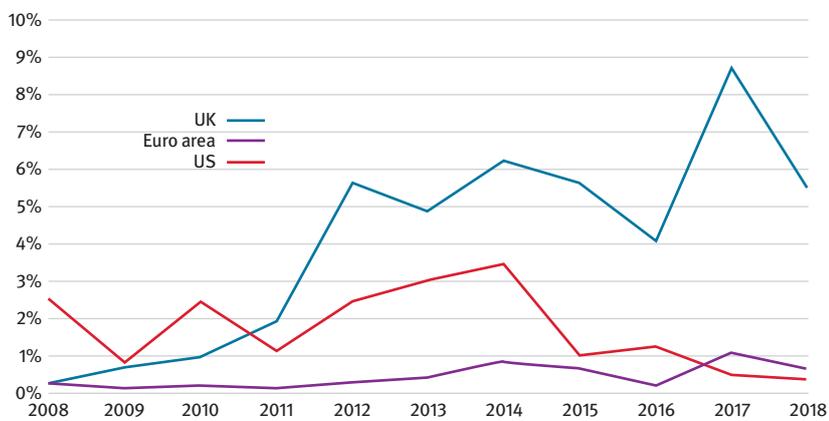
“Misconduct might be linked to poor corporate governance.”

11. The distribution of the 20 banks by geographical areas - US, Euro area, Swiss and UK banks, was made according to each bank's reported headquarters.

“Misconduct by banks can weaken confidence in economically important markets.”¹²

To put the misconduct costs into context, Figure 4 illustrates the ratio of conduct costs to the Gross Domestic Product of each country / geographical area, for these 20 banks. It can be seen that conduct costs represent a significant proportion of GDP.¹³ In 2017, conduct costs were at the highest recorded level for UK banks, representing 0.88% of the UK annual GDP. In the US, where the conduct costs peak was in 2014, it represented 0.35% of annual GDP.

Figure 4: CONDUCT COSTS TO GDP RATIO



12. ESRB, “Report in misconduct risk in the banking sector”, June 2015.

13. GDP for UK, Euro Area and US (source: Tradingeconomics.com/world bank)

International results table: periods 2013 – 2017 and 2014 – 2018

Table 1 displays the total conduct costs and provisions (and contingent liabilities) at the end of each period, for both periods (2013-2017 and 2014-2018).¹⁴ In summary, and for the period 2014-2018, the five worst performers were: The Royal Bank of Scotland (RBS), Bank of America (BAC), Lloyds Banking Group (LBG), Deutsche

Bank (DB) and Barclays, and the five best performers were: ING Group (ING), Standard Chartered (SC), Santander (SAN), Commerzbank (CBK) and National Australia Bank Group (NAB).

PROVISIONING FOR CONDUCT COSTS

In this report, conduct costs are 'attached' to the date on which a liability 'crystallises'. However, banks are required to make adequate provisions for the periods they expect to face any likely conduct costs. We also incorporate this information, as it provides a clearer picture

Table 1. INTERNATIONAL RESULTS TABLE: PERIODS 2013 – 2017 and 2014 – 2018 (GBP Bn)

Banks	Total costs 2014-2018 (GBP Bn)	Provisions as at 31 Dec 2018 (GBP Bn)	Grand Total 2014-2018 (GBP Bn)	Total costs 2013-2017 (GBP Bn)	Provisions as at 31 Dec 2018 (GBP Bn)	Grand Total 2013-2017 (GBP Bn)	Total costs 2012-2016 (GBP Bn)	Provisions as at 31 Dec 2016 (GBP Bn)	Grand Total 2012-2016 (GBP Bn)
RBS	24.56	2.00	26.56	20.98	5.81	26.79	10.50	11.03	21.53
BAC	25.04	1.50	26.54	36.60	0.96	37.57	44.61	1.01	45.62
LBG	15.21	3.58	18.79	16.07	4.07	20.14	16.87	3.60	20.47
DB	13.74	3.89	17.63	13.72	4.21	17.92	6.92	6.64	13.57
BARC	14.20	1.75	15.94	12.93	2.68	15.61	13.18	3.87	17.05
JPMC	13.48	1.18	14.66	24.86	1.26	26.12	32.62	2.79	35.41
CITI	13.18	0.79	13.97	15.46	0.90	16.36	15.78	2.04	17.82
WFC	11.80	2.13	13.93	10.66	2.00	12.66	10.41	2.43	12.84
GS	10.51	1.50	12.01	10.43	1.11	11.54	10.56	1.46	12.02
BNP PARIBAS	8.89	1.78	10.66	8.39	2.89	11.28	7.41	2.93	10.34
MS	8.30	1.03	9.32	9.58	1.46	11.04	11.48	12.89	24.36
HSBC	7.66	1.58	9.24	7.38	3.76	11.14	8.53	2.89	11.42
CS	7.05	1.67	8.72	7.19	3.78	10.97	4.68	3.93	8.61
UBS	3.95	1.56	5.51	3.43	1.86	5.29	3.63	2.59	6.23
SOC. GEN.	3.86	1.19	5.05	1.48	2.12	3.60	0.56	1.90	2.46
NAB	2.31	0.39	2.70	2.10	0.54	2.64	2.40	1.12	3.52
CBK	1.38	1.15	2.52	1.57	0.76	2.33	1.65	0.29	1.94
SAN	1.64	0.37	2.01	1.73	0.46	2.19	1.93	0.56	2.49
SC	0.45	0.83	1.28	0.49	0.07	0.56	0.91	0.08	0.99
ING	1.09	0.15	1.24	0.23	0.32	0.55	0.61	0.30	0.91
Grand Total	188.30	29.98	218.28	205.28	41.03	246.31	205.26	64.36	269.61

14. The Conduct Costs Project previously published its results in a form of an International Results Table, on the basis of 'rolling' five-year periods. The last update, published in 2017, covered the results for the period 2012-2016.

Table 1 present an update of the International Results previously published. For reference, the total of conduct costs and provisions for the period 2012-2016 was also included. The findings are underpinned by data that are continually the subject of identification and verification as further (and/or better) information is available in the public domain.

Figure 5: CONDUCT COSTS AND PROVISIONS, BY PERIOD (GBP Bn)

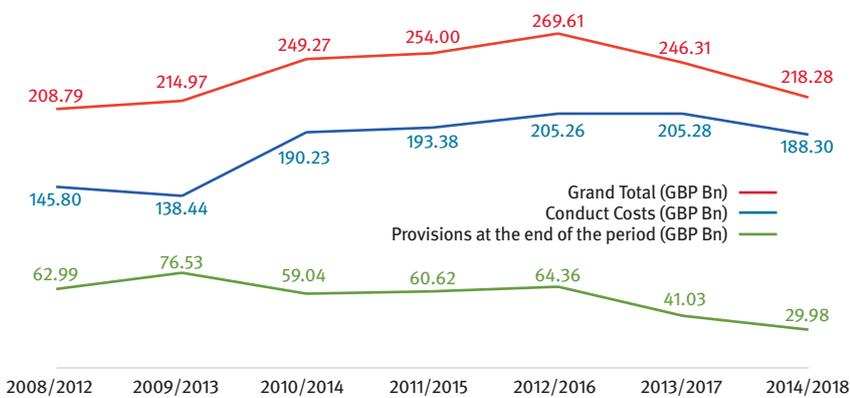


Figure 6: COMPARATIVE TRENDS OF THE CONDUCT COSTS, FOR THE 20 BANKS (GBP Bn)



of a bank’s conduct risk. The end-of-year provisions offer a glimpse of trends into the following year (s), on expected conduct costs and losses. Moreover, provisioning may be influenced by new policies and rules or reflect the results of investigations of market practices that span across multiple institutions.

The provisions were collected from the notes to the financial statements and we ensured that the collection only includes provisions that relate to conduct costs.

In the past years, the banks have put aside substantial provisions to address conduct costs. Figure 5 illustrates the relationship between the total of conduct costs crystallised during a given period and the provisions as at 31 December of the final year.

While the amount of conduct costs across all 20 banks has increased over the six (five-year) periods, it has decreased in the latest period (2014-2018). The provisions, which had remained stable throughout until the period 2012/2016, have also declined in the last two periods.

The conduct costs (and provisions) may also affect banks’ capital ratios, bank equity returns, and valuations¹⁵. Figure 6 shows the trends in the total conduct costs (between 2008 and 2018, on a 5-year “rolling” basis) on a bank-by-bank basis. The charts illustrate important differences among our sample banks and highlight some trends. For our sample US banks, starting in the period 2012-2016, conduct costs are decreasing. On the contrary, the trend is increasing for Euro Area and UK banks, as the latter have been receiving an increasing number of regulatory fines and sanctions.

15. See report ECB, Financial Stability Review, November 2019.

Project's metrics (2008 – 2018)

Banks have been affected by conduct costs relating to a broad range of issues.

CAUSE CODES

A key contribution of this project is the categorisation of events in Cause codes, to reflect the fact that not all conduct issues are the same.

Figure 7: CONDUCT COSTS, CAUSE CODE (GBP Bn)

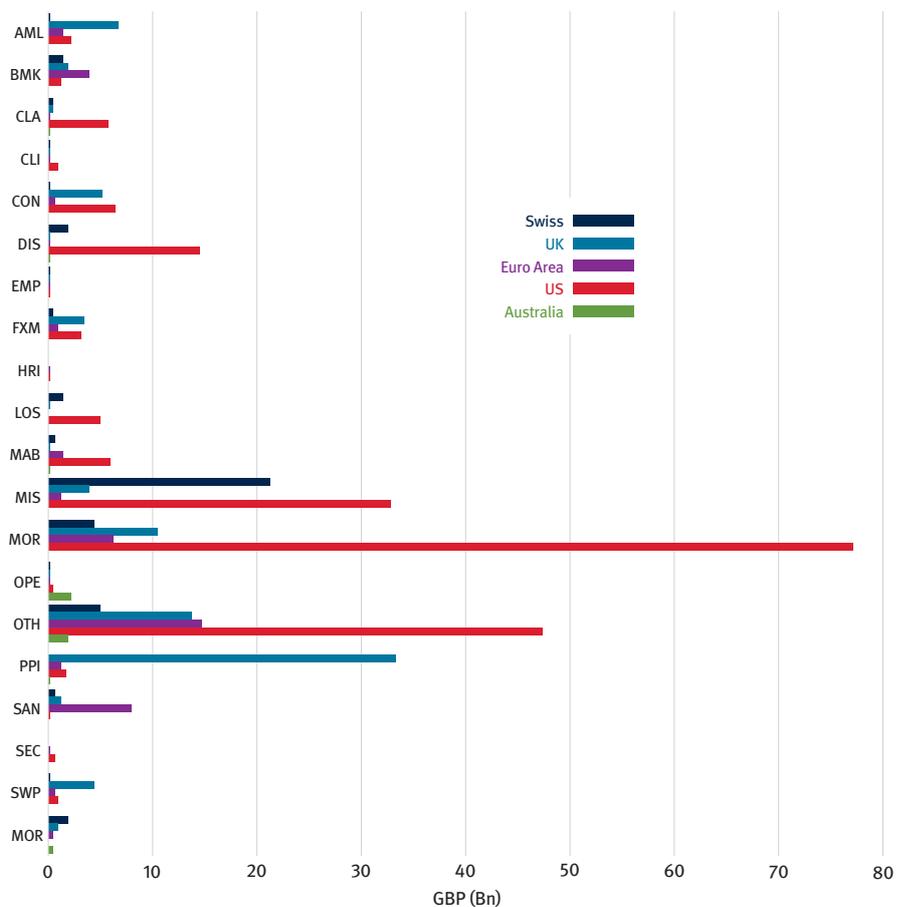


The Cause codes indicate the circumstance giving rise to the cost. For example, it illustrates whether the charges are related to Foreign Exchange (FXM), LIBOR and Euribor Manipulation (BMK), Money laundering (AML), Tax evasion (TAX), PPI, Swaps mis-selling (SWP) or residential mortgage-backed security mis-selling (MOR), for example. A list of the Cause codes is provided in Appendix II.

In aggregate, the conduct costs for the period 2008 – 2018, ranked by the relative Cause codes, are displayed in Figure 7.

The allocation of conduct costs to Cause codes also reflects which occurrences took place across geographical areas (Figure 8). This categorisation allows us to highlight some important differences.

Figure 8: CAUSE CODES BY GEOGRAPHICAL AREA (GBP Bn)



For UK banks, the majority of conduct costs were related to mis-selling (MOR, PPI, SWP), money-laundering related issues (AML), and defective internal controls (CON).

For the Euro Area banks, conduct costs were predominantly a result of mortgage-related issues (MOR), market abuse and manipulation (MAB), and benchmarks (BMK), money-laundering related issues, and breach of economic sanctions (SAN).

In the US banks, conduct costs were related mainly to developments that have taken place in the mortgage market following the subprime crisis (MOR), Market Abuse and Manipulation (MAB) and related to Foreign Exchange markets manipulation (FXM), failures to disclose as required by law or regulation (DIS) and defective internal controls (CON).

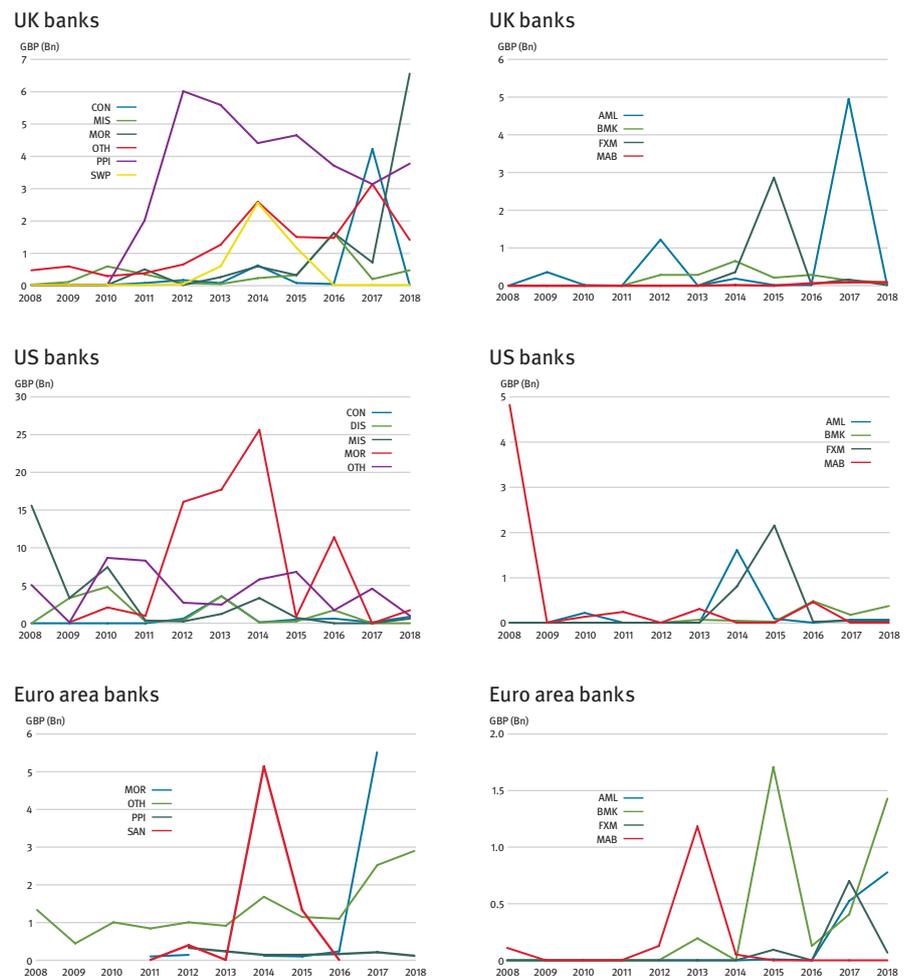
Moreover, in all jurisdictions the amount of conduct costs allocated to the code OTH is significant. As the description of this code indicates, it relates to “other events”, including governance and management failure. It is, of course, possible that part of these OTH conduct costs could relate to conduct failings within other categories (e.g., as stated on the disclosures within the banks’ annual report and accounts - “Provisions utilised: legal, competition and regulatory matters”). Further research would be needed to look into this in greater depth.

For completeness, Figure 9 provides an indication of trends for the US, UK, and Euro Area banks, by Cause codes.

Some of the conduct costs - MOR, MIS, BMK, for example, have been increasing, suggesting potential circumstances that give rise to conduct costs that might be expected in the near future (e.g., litigations that cut across multiple financial institutions and multiple regulatory and law enforcement agencies).

The Project has also attributed Cost codes and Culpability codes to each entry in the conduct costs dataset, which underlined the misconduct of the banks.

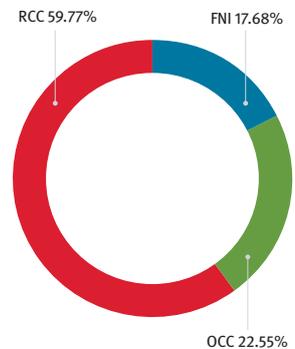
Figure 9: CAUSE CODES FROM 2008 TO 2018 (GBP Bn)



COST CODES

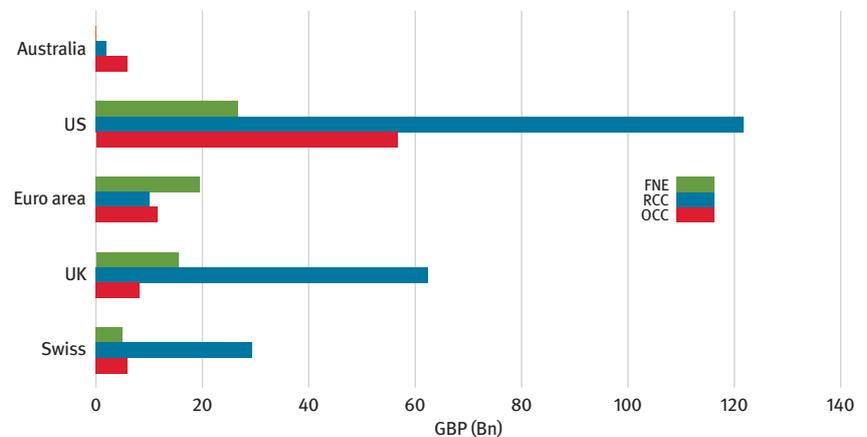
Cost codes consider the fact that the consequences of misconduct are not only a matter of fines and penalties. For the 20 banks in our sample, between 2008-2018, 59.77% of their conduct costs were assigned to the cost code RCC, which is defined as the conduct costs arising out of a regulatory directed redress, irrespective of whether it resulted in formal proceedings, fines or penalties (other than FNE). FNE events, that is, fines and penalties imposed by a regulatory and other conduct authority, amount to 17.68% for the same period (Figure 10).

Figure 10: CONDUCT COSTS FOR THE YEARS 2008-2018, ACROSS ALL 20 BANKS, SPLIT BY COST CODES (GBP Bn)



For completeness, Figure 11, illustrates the distribution by geographical area of the banks, categorized by Cost codes.

Figure 11: COST CODES BY GEOGRAPHICAL AREA (GBP Bn)



CULPABILITY CODES

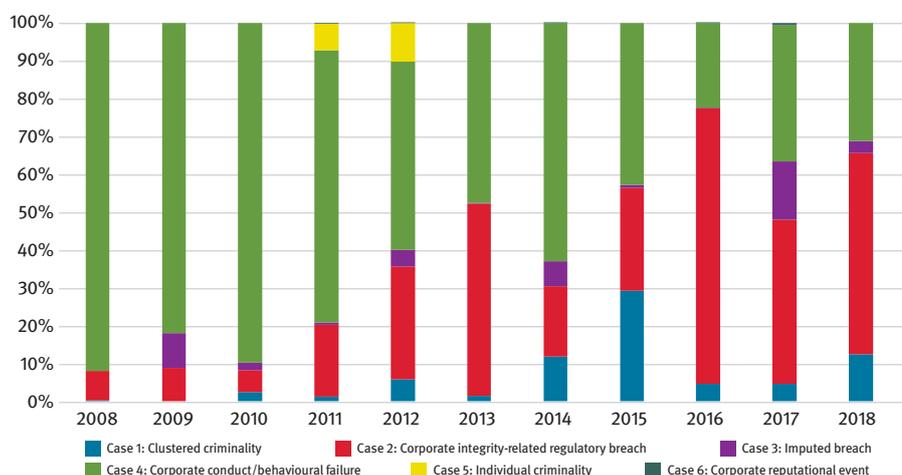
The allocation of conduct costs to Culpability codes allows us to rank the conduct costs according to the degree of moral or ethical culpability. We identify seven culpability codes, as follows: (i) Clustered Criminality; (ii) Corporate integrity-related regulatory breach; (iii) Imputed breach; (iv) Corporate conduct/behavioural failure; (v) Individual Criminality; (vi) Corporate reputational event and (vii) Individual reputational event¹⁶. The majority of events were, unsurprisingly, assigned to either Case 2 and Case 4, given the amount of fines and regulatory-related conduct costs (Figure 13).

failings tied to a regulatory breach illustrate inadequate “systems and controls”.

Case 4 applies to similar events to those included Case 2; however, such circumstances arise out of a pattern of behaviour and do not necessarily involve a clear regulatory breach.

Alongside Case 2 and Case 4 allocations, it is noted that Case 1 – ‘Clustered Criminality’ -, includes such events that impact directly on the perception of an institution’s culture and trustworthiness. This culpability code features from 2010, due to the widespread manipulation of inter-bank and foreign

Figure 12: CONDUCT COSTS, CULPABILITY CODES (GBP BN)



Case 2 captures the largest proportion of conduct costs given, the predominance of regulator-led redress (e.g., MOR market mis-selling and PPI mis-selling). Moreover, Case 2 includes all conduct that undermines the integrity of the bank, with great reputational damage, as the serious corporate governance

exchange benchmarks. This is a reflection of the highly egregious nature of such transgressions.¹⁷

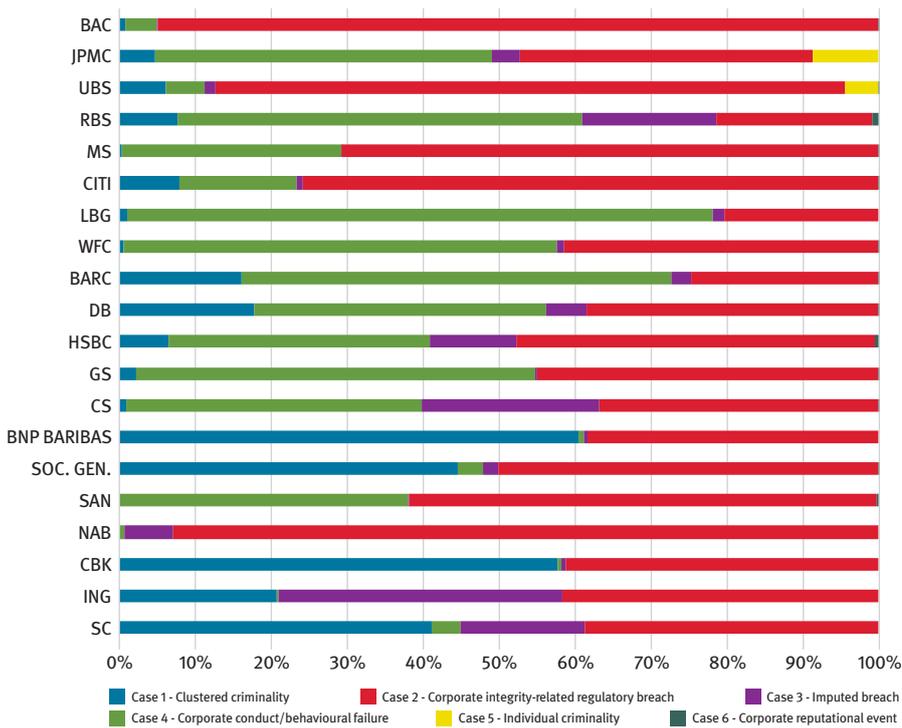
Additionally, with a smaller proportion of allocations, Case 3 – ‘Imputed Breach’, relates to instances in which a bank is not the

16. The definition of the culpability codes is reported in Appendix II.
 17. McCormick, R., Duarte, T. and Stears, C., “Seven deadly sins: “retrospectivity, culpability and responsibility”, Law and Financial Markets Review, April 2016.

“primary criminal” but it has committed a criminal offence or regulatory breach that is closely linked to, and arises by reason of, another’s (actual or potential) criminal act. Such events involve systemic failures on the part of banks to help with the effort to control organised crime, terrorism, and

tax evasion (e.g., failure to comply with AML requirements and insufficient controls concerning a customer’s tax evasion). Figure 13 displays the culpability ‘scoring’ system allocated to the conduct costs of the 20 banks, period 2008-2018.

Figure 13: CULPABILITY CODES BY BANK (GBP Bn)



Limitations

It is acknowledged that the banks analysed by this project have different business models, dimensions, and operate in various jurisdictions. Furthermore, some jurisdictions may appear to be more affected by misconduct than others. These differences can be, at least in part, due to more disclosure by authorities (not all the regulators reveal to the public if they impose a fine to a bank, for example). In some instances, misconduct episodes were uncovered after media scrutiny and public pressure, which, again, might be different across jurisdictions.

It is also important to mention that a regulator may give some banks immunity if they “co-operate”. For example, in December 2013, Barclays received immunity for revealing the existence of the cartel in Euro Interest Rate Derivatives (EIRD) and thereby avoided a fine of around €690million for its participation and infringement.¹⁸ Likewise, in December 2016, Deutsche Bank received full immunity for revealing the existence of the Euribor Cartel to the Swiss competition regulator - COMCO.¹⁹

More recently, in May 2019, the European Commission fined Barclays, RBS, Citigroup, JP Morgan, and MUFG, €1.07 billion, for participating in a foreign exchange spot trading cartel. UBS received full immunity for revealing the existence of the cartels to the Commission, thereby avoiding an aggregate fine of ca. €285 million.²⁰

18. European Commission Press Release, Antitrust: Commission fines banks € 1.49 billion for participating in cartels in the interest rate derivatives industry, 4 December 2013.

19. Competition commission COMCO, Press Release, 21 December 2016.

20. Conduct Costs Reporting Framework (<http://conductcosts.ccpresearchfoundation.com/cc-reporting-proposal>).

“There is an urgent need to promote a change in culture within banks, in order to reconnect finance to the real economy and its stakeholders.”

Drivers of progress

Banks conduct costs tell the story not only of specific financial institutions, their systems, and controls, governance and culture, but also the story of the individuals within the institution, their ethics, values and competence gaps. There is a connection between the institutions’ ethics and culture, and the frequency and severity of the misconduct. Likewise, conduct costs are an objective indicator of the negative effect of an inappropriate culture.

It has been suggested that the willingness of a bank to engage in misconduct can be driven by an institution’s risk culture and risk appetite, or even due to industry-wide trends. This may be enabled by the bank’s poor governance, weak organisational policies and processes, as well as by inappropriate behaviour of individual employees.

Financial institutions are facing increasing pressure from regulators and stakeholders to improve the quality of bank governance, the competence and effectiveness of their systems and staff members, and to disclose more information with authorities and peers.

It is reasonable for shareholders and stakeholders to be concerned about banks’ conduct costs. While some information is provided within the Notes to the financial statements, this is often in very general terms. Traditionally, banks do not report on what their Conduct Costs represent for their shareholders and stakeholders, in terms of meeting their “trust and cultural change” objectives, risk management, and financial performance.²¹

The CBR Conduct Costs Project’s dataset provides information on the sample banks’ conduct costs with no minimum threshold of

conduct costs, and therefore has the potential to identify and access the following: ‘root causes’; early trends in systemic misconduct; resource allocation inadequacies; training and competence requirements and to demonstrate transparency in such matters to stakeholders.

The conduct costs results and the underlying data (when assessed against comparative results) can complement existing in-house data sets, designed to inform the assessment of conduct risk, cultural identity and associated strategic objectives – providing valuable insight into root causes, inadequate resources, training and competence gaps (and regulatory risk). Despite an apparent reduction in conduct cost in recent years, it is recognised that the monitoring of all conduct costs might prevent systemic risks that would weaken trust in both financial institutions and markets. Additionally, and depending on the nature and amount of time for investigations and trials, it is likely that some conduct costs could generate stock market and public reactions that might become an issue of greater magnitude.

These numbers reveal a very concerning picture of banks’ performance after the 2008 financial crisis, and an extreme misalignment with the transparency and ethics needed to achieve the Paris Agreement and the Sustainable Development Goals.²² There is an urgent need to promote a change in culture within banks, in order to reconnect finance to the real economy and its stakeholders.

21. Conduct Costs Reporting Framework (<http://conductcosts.ccpresearchfoundation.com/cc-reporting-proposal>)

22. Santos, S. and Duarte, T., “O Setor Financeiro e o Crescimento Sustentável – A nova finança do Século XXI”, Almedina, January 2019

Conclusions and next steps

This report has sought to give shareholders (and stakeholders) greater insight into a bank's culture, conduct, competence and regulatory risks. The numbers recorded against a bank's conduct costs might assist in explaining low profitability and share price performance. Moreover, the level of comprehensiveness of the dataset, besides adding context to the conduct costs, provides a valuable insight into a bank's non-financial conduct performance.

From an investor perspective, this information is very important. The project enables shareholders and stakeholders to access a unique dataset, which can provide a valuable tool to investors looking for information on a bank's conduct risk management.

NEXT STEPS

The project will continue to work on updating the dataset, alongside with analysing the conduct performance of each bank. From cause to consequence (and its relative culpability), comprising various jurisdictions, the project will henceforth focus on European banks for the near future. Moreover, the project research team is working on the development of a Conduct Cost Index, to be published in 2021.

FIND OUT MORE

Centre for Banking Research
The Business School
(formerly Cass)

T: 020 7040 5230

E: bankingcentre@city.ac.uk

www.cass.city.ac.uk/cbr

“Our comprehensive dataset, besides adding context to the conduct costs, provides a valuable insight into a bank's non-financial conduct performance.”

Appendix I: Glossary

The working definition was prepared by the CCP Research Foundation and consists of:

Conduct costs - Conduct costs means all costs borne by a Bank in connection with any of the following:

- I. Regulatory proceedings, specifically (but not exhaustively):
 - a. fines or comparable financial penalties imposed on the Bank by any Regulator;
 - b. any sum paid to a Regulator or at the direction of a Regulator in settlement of proceedings of any kind;
 - c. any sum paid to, or set aside to be paid to, any third party or parties to the extent required by any Regulator; and
 - d. any sum paid, or set aside, for the purchase (or exchange) of securities or other assets to the extent required by a Regulator and (if such information is available) to the extent such sum exceeds the open market value of such securities or other assets as at the date of purchase;
- II. Any costs, losses or expenses which are directly related to an event or series of events or conduct or behaviour of the Bank or a group of individuals employed by the Bank for which any fine or comparable penalty has been imposed or any censure issued by a Regulator;
- III. Any sum that has become payable as a result of, or in connection with, any breach of any code of conduct or similar document entered into, or committed to, at the request of, or required to be entered into or committed to by, any Regulator or any public, trade or professional body;
- IV. Any loss of income or other financial loss attributable to a requirement imposed by a Regulator to place money on deposit with a central bank or other institution at below the market rate of interest, being a requirement imposed in connection with a breach of law or Regulatory requirement;
- V. Any sum paid in connection with any litigation (whether ordered to be paid by a court or tribunal or in settlement of proceedings) where the litigation involved allegations of material wrongdoing or misconduct by senior officers or employees of an institution which were not refuted;
- VI. Any other sum, cost or expense, not falling within any of (i) to (v) above that is paid pursuant to an order or requirement of a Regulator and which is a result of any breach of any regulatory requirement or law.

Appendix II: Cause Codes, Cost Codes and Culpability Codes

CAUSE CODES	DEFINITION
PPI	PPI provisions, as published by bank.
AML	Money-laundering related issue.
MAB	Market-abuse related issue (including insider dealing).
SAN	Sanctions contravention.
MIS	Mis-selling other than PPI or mortgage market /swaps.
CLA	Adverse judgement / settlement in class action v bank (or one or more officers).
CON	defective internal controls (including rogue trader).
SEC	Breach of confidentiality.
CLI	Client money failing.
DIS	Failure to disclose as required by law or regulation.
TAX	Payment related to tax irregularity (including failure to comply with undertaking).
LOS	Egregious loss due to bad judgment (e.g. London Whale) (not include rogue trader).
ENV	Environmental issue.
EMP	Employment issue.
HRI	Human Rights issue.
BMK	Benchmark manipulation, specifically interbank offered rates (LIBOR etc).
FXM	Foreign Exchange Market Abuse/Manipulation.
MOR	Mortgage market mis-selling (including primary and secondary markets; retail and wholesale e.g. origination and foreclosure abuses as well as RMBS).
SWP	Swaps mis-selling, specifically IRHP.
OPE	Operational Risk issues not covered by any of the above categories.
OTH	Other event indicating governance / management failure (not failing within any of the above categories).
PVN	[Financial] Provisions made in respect of any of the above categories.

COST CODES	
FNE	Fines and/or Penalties imposed by a regulatory and/or other 'Conduct' authority.
RCC	Conduct Costs that arise out of a regulatory directed redress, whether or not it results in formal proceedings, fines or penalties (Other than FNE).
OCC	All Other Conduct Costs.

CULPABILITY CODES	
Case 1 “Clustered Criminality”	This is where there is at least strong suspicion that a crime has been committed and although the culprits may not be immediately clear it seems likely that more than one person was involved. Classic examples: fraudulent manipulation of markets or benchmarks such as LIBOR, concerted complicity in tax evasion and breach of US sanctions regimes.
Case 2 “Corporate integrity-related regulatory breach”	This applies where there has not been any criminality but there is a clear and egregious breach of regulation that impugns the integrity of the institution. This will also include serious corporate governance failings tied to a regulatory breach such as inadequate ‘systems and controls’, irrespective of whether or not there has been customer detriment or loss and misconduct of a systemic nature with high reputational damage. Examples: PPI mis-selling or mis-handling of client money.
Case 3 “Imputed breach”	This would be the case where a bank is not the “primary culprit” but it has committed a criminal offence or regulatory breach that is closely linked to, and arises by reason of, another’s (actual or potential) criminal act. Examples: failure to comply with AML requirements and insufficient controls in relation to a customer’s tax evasion (in relation to which new criminal offences have been proposed by various politicians in the wake of the HSBC Switzerland affair).
Case 4 “Corporate conduct/behavioural failure”	This is similar to, but less serious than, Case 2. It does not, necessarily involve a clear regulatory breach (or the breach might be of a more technical nature (such as IT system failures) that does not necessarily impugn the integrity of the bank (it does not represent endemic misconduct)). Rather, it arises out of a pattern of behaviour (e.g. “poor practices”) where the bank accepts that some redress to its customers is appropriate. Example: the FCA redress scheme for SME customers who have allegedly been mis-sold IRHP and other products. (This may turn out to be sui generis; the FCA itself refers to it as a “unique solution to a specific set of concerns”).
Case 5 “Individual Criminality”	This is where there is clear evidence that a crime has been committed by a bank employee and the culprit (usually acting alone) is identified. Classic examples: insider trading and the “rogue trader”.
Case 6 “Corporate reputational event”	This arises where the bank’s reputation is severely damaged even though it may not have committed any crime or breach of regulation. Examples: the difficulties experienced by RBS in relation to GRG and its alleged harsh treatment of borrowers in default and the problems encountered by HSBC in relation to alleged complicity in its customers’ alleged “aggressive tax avoidance”. Egregious, unjustified bonus payments could also fall into this category. Pending crystallisation of an event into a conduct cost, Provision items that cannot be assigned to another Case, are assigned to Case 6.
Case 7 “Individual reputational event”	This Case is for situations (not falling within any other Case) where a person employed by the bank or in some way associated with it behaves in a way that attracts criticism not just of that person but also of the bank itself. Example: the events reported in relation to the former Chairman of the Co-op Bank, Paul Flowers.

Business School (formerly Cass)

106 Bunhill Row

London EC1Y 8TZ

T: +44 (0)20 7040 8600

www.cass.city.ac.uk



youtube.com/cassprogrammes



Cass Business School



@cassbusiness



facebook.com/cassofficial



instagram.com/cassbusinessschool



City, University of London is an independent member of the University of London which was established by Royal Charter in 1836. It consists of 18 independent member institutions of outstanding global reputation and several prestigious central academic bodies and activities.

Disclaimer: All the information contained within this brochure was correct at the time of going to print. Published August 2020.

