
A QUESTION OF ETHICS

NAVIGATING ETHICAL FAILURE IN THE
BANKING AND FINANCIAL SERVICES INDUSTRY





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The Centre's programs target change at three levels:

- The development of individual ethical leadership capabilities of program participants
- Building more effective and more ethical cultures, systems and processes in the host organisations of program participants and industry partners
- Engaging our program participants and leaders from industry in ongoing cross-sectoral conversations and learning about ethical leadership.

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"ETHICS IS NOT DEFINABLE, is not
implementable, because it is not conscious;
IT INVOLVES NOT ONLY OUR THINKING,
BUT ALSO OUR FEELING."

VALDEMAR W. SETZER,
BRAZILIAN ANTHROPOLOGIST

EXECUTIVE SUMMARY

Since the global financial crisis (GFC), financial institutions and practitioners in Australia, New Zealand and Asia have come under scrutiny for a range of ethical transgressions leading to industry scandal, as have their more well-known counterparts in the United States and United Kingdom.

Some scandals were caused by people who – driven by greed and the demands of a complex, fast-paced industry – chose to behave unethically. However, evidence from social psychology points to an alternative explanation: a good deal of unethical behaviour is also unconscious.

In *A Question of Ethics*, we draw on themes and findings from various industry scandals to examine contributing factors at the structural, social and individual levels that influence ethical conduct, and how these may be distorted by what social psychologists refer to as cognitive biases. We present data from a six-country survey of banking and financial services industry practitioners, which explores attitudes towards questionable practices and seeks views about the potential for ethical improvement.

The majority of practitioners we surveyed believe that company policies and legal requirements are the most influential factors driving their ethical decisions. Of the seven ethically questionable practices we examined, respondents rated mis-selling as the most unethical (and least necessary) and

risk-based profiling as the least unethical (and most necessary). When asked about the prevalence of such practices in the industry, respondents perceived a higher occurrence in their countries as a whole than within their own companies. Finally, respondents identified clearer company standards and greater accountability as the most effective strategies for encouraging ethical behaviour.

Drawing on what industry practitioners tell us, learnings from industry examples of ethical failure, and on research in social psychology, ethics and human decision-making, the paper concludes by proposing a range of culture-shaping interventions that are designed to improve ethical behaviour in the banking and financial services sector, including:

- Harnessing data analytics to measure and reward non-financial performance.
- Engaging in conscious, principled reasoning: focusing on explicitly stated non-negotiable principles instead of cost-benefit calculations.
- Reducing the risk of insularity and groupthink by encouraging a diverse range of views, from team to board level.
- Making ethics part of the everyday conversation- looking at how tools such as 'ethical moments' and decision-making frameworks can help individuals to prioritise ethics.

INTRODUCTION

The banking and financial services sector performs a valuable role in society, but recurrent, highly publicised scandals have inflicted major losses and distress in recent times, and have undermined the reputations of firms and individuals.

Rates have been manipulated and financial products mis-sold in markets throughout Asia and the rest of the world. Many such scandals have been the subject of government and regulatory investigations.

In Australia, financial services regulator the Australian Securities and Investments Commission (ASIC) recently charged three major banks and is investigating a fourth¹²³ with unconscionable conduct and market manipulation in relation to the bank bill swap rate. The banks are contesting the claims. Parliamentary inquiries are investigating the quality of advice from financial advisers,⁴ and the alleged impairment of commercial loans by a major bank.⁵

Similar inquiries have been conducted in Hong Kong⁶⁷ and the United Kingdom.⁸ Despite the best efforts of authorities to address the factors contributing to these ethical failures, they continue to occur.

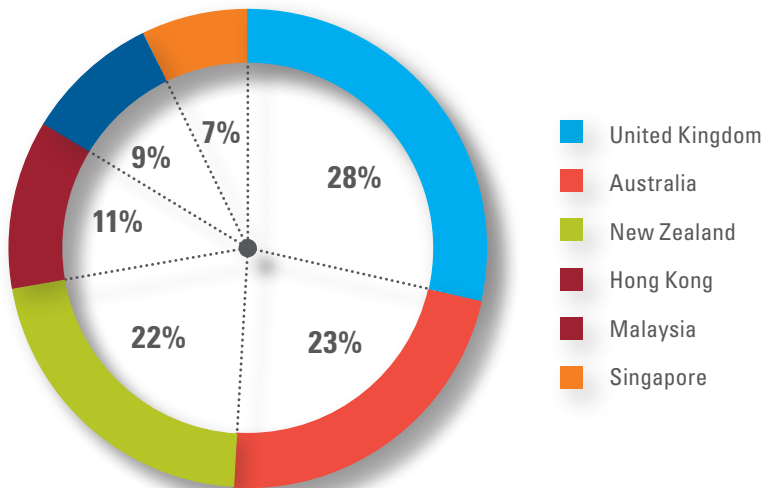
In the eyes of many, these scandals provide further evidence of issues with the ethical culture of the banking and financial services sector – and it is not only people outside the sector who hold this view. In a recent survey of financial services employees in the United States and United Kingdom, almost a quarter of respondents believed that unethical practices were widespread in their company, up from 12% three years prior.⁹ The same survey found that the larger their income, the more likely respondents were to report having observed unethical behaviour, the more willing they were to engage in illegal practices

if they believed there was little chance of getting caught, and the more likely they were to report that the industry did not put client interests ahead of its own.

At first glance, there appears to be ample grounds for pessimism. **BUT THIS PAPER WILL CHALLENGE THAT PESSIMISM.**

Using findings from social psychology we demonstrate how the pressures of the banking and financial services industry can affect decision-making, and how the same cultural factors that threaten ethical behaviour can be turned around to encourage it.

CHART 1: SURVEY PARTICIPANTS: COUNTRY OF RESIDENCE

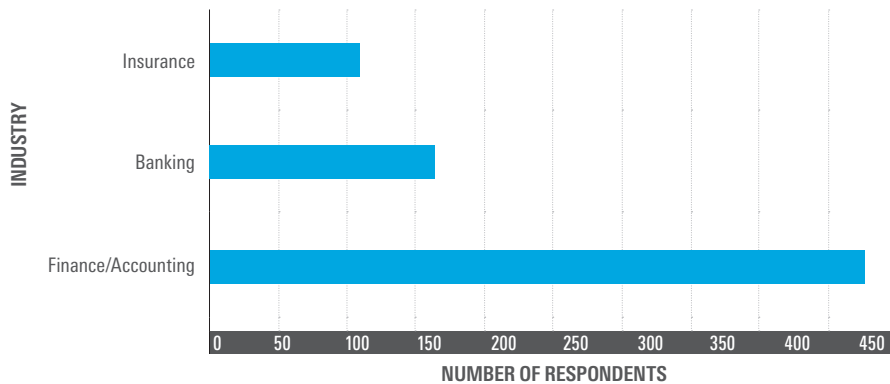


Specifically, we will examine structural, social and individual factors endemic in the industry that have both conscious and unconscious influences on ethical decision-making.

We draw on evidence from a survey of 705 practitioners in the banking and financial services industry across Australia, New Zealand, the United Kingdom, Singapore, Hong Kong and Malaysia. Respondents were

asked about what guides them to engage in ethical behaviour at work, the nature of current industry practices and what would improve ethical behaviour in the future. They had an average of 13 years' experience in their current professions.¹ For more information about survey participants, see Charts 1 and 2.

CHART 2: SURVEY PARTICIPANTS: INDUSTRY OF EMPLOYMENT



¹Ranging from less than 1 year to 50 years of experience.

ETHICALLY QUESTIONABLE PRACTICES IN THE BANKING AND FINANCIAL SERVICES INDUSTRY

The practices summarised below were identified by industry experts as having existing or emerging ethical implications. Survey respondents were asked about their attitudes towards these practices.

COMPENSATION STRUCTURES AND MORAL HAZARDS

Modern financial institutions reward their employees for delivering specific outcomes, often without taking into account the means by which they are achieved. Traders in banks, for example, may receive bonuses for taking excessive risks with investors' money with little or no regard for the interests of the bank's shareholders or the long-term stability of the banks themselves. This creates a moral hazard, a situation in which the trader is insulated from the risk of personal financial loss, and therefore behaves differently than if they were exposed. The consequences of moral hazards can be disastrous, both for individuals and institutions. Barings Bank collapsed in 1995 as a result of Nick Leeson's unauthorised speculative trading, and an inestimable number of people and institutions suffered as a result of reckless risk-taking in the lead up to the GFC.

MARKET RIGGING

Market rigging refers to manipulation of prices for a security or product so as to gain an unfair market advantage. It often involves collusion between usually competitive corporations, including financial institutions. Financial markets rely upon benchmarks for quantifiable value of their products, such as securities and foreign currencies.

The strength of a free-market economy, it is argued, is in its ability to self-correct. Market rigging undermines this by not only manipulating supply and demand, but by violating the fundamental assumption of neoclassical economics: that people act on the basis of full and relevant information. When markets are deliberately altered, everyone who operates in them is affected, including mortgage holders, shareholders, investors, employees, pensioners and retirees.

MIS-SELLING

Mis-selling occurs when a product (especially a financial service) is sold to a customer on the basis of misleading advice. Mis-selling exploits customers' relative lack of understanding of complex products to benefit vendors, who often receive significant incentives for the sales. The large-scale Payment Protection Insurance mis-selling scandal in the United Kingdom and the misrepresentation of high-risk investment products by New Zealand finance companies are two well-known examples.

DATA PRIVACY

Of increasing ethical concern in the banking and financial services sector is the potential for data to be used without full consent. The way personal data is collected, stored and utilised has evolved significantly in recent times. This data

now provides a rich source of business intelligence and allows companies to personalise the consumer experience. Customers often volunteer their data freely, believing it to be in their best interests, but the data may not be used for its original purpose. This is of ethical concern due to the sensitive nature of personal information and further security risks posed by third party access.

RISK-BASED PROFILING

Risk-based profiling and pricing is, fundamentally, an alignment of loan pricing with expected loan risk. Specifically, it refers to the use of particular tools by lenders to profile customers in order to determine their credit risk and compensate by varying the interest rates and fees that apply. Risk-based profiling is an accepted practice in many mature markets, including the United States and the United Kingdom, but is still gaining traction in markets like Australia and New Zealand.

Proponents of risk-based profiling claim that it more closely tailors products to consumers' needs, as well as increases the availability of credit for those who may have previously been denied. While profiling is advantageous for customers in a sound financial position, who attract lower interest rates, the flipside is that those with less capacity to pay attract higher rates, which are profitable for the lender, but potentially unsustainable for the borrower.¹⁰ In this context (when rates vary by individual), lenders that advertise low interest rates may be misleading customers.

TAX AVOIDANCE

Tax avoidance refers to the use of legal methods to arrange a company's affairs so that tax contributions are minimised. Although governments around the world tacitly supported these methods in the past, perceptions are now changing, with growing public sensitivity to a lack of tax paid in the context of billions of dollar of profit. Ethical concern is largely directed at multinational companies, which can shift their profits to low- or no-tax jurisdictions at the expense of domestic companies and economies. Tax avoidance reflects a fundamental conflict between the corporate and public interest: for companies, taxes are additional costs to be minimised in order to maximise profit and shareholder returns; for the public they form a revenue base that supports state functions, such as maintenance of infrastructure and protection of citizen welfare.¹¹

CLIPPING THE TICKET

Clipping the ticket refers to the practice of adding a service or commission fee onto the price of a product in situations where the product is being on-sold or sold on behalf of someone else. Often this takes place in the context of 'preferred provider' arrangements between companies, or, in a vertical integration model, between different functions within the same organisation. Clipping the ticket presents a potential conflict of interest among advisers who are more likely to sell or promote products for which they anticipate receiving a fee or commission.

ETHICAL BEHAVIOUR

WHY BEHAVE ETHICALLY?

Ethical standards may vary widely, but nearly everyone has some. Research from social psychology shows us that structural, social and individual factors can influence whether or not our ethical standards are translated into ethical conduct.

STRUCTURAL REGULATION OF ETHICAL BEHAVIOUR

At the structural level are external factors such as laws, regulations, policies and procedures. A properly enforced code of conduct, for example, has been found to reduce the incidence of unethical behaviour.¹²

Most people are aware of the role that rules and regulations play in deterring unethical behaviour, but powerful SOCIAL AND INDIVIDUAL INFLUENCES OFTEN GO UNNOTICED¹³

This is reflected in our survey data shown in Figure 1. When asked to rate the factors that guide ethical behaviour in the workplace, a majority of respondents ranked external factors such as codes of conduct, regulations, and laws in their top five.

SOCIAL REGULATION OF ETHICAL BEHAVIOUR

Many people are strongly influenced by the expectations and reactions of their colleagues, clients and leaders. They may be conscious of these influences (for example, if they choose a course of action to avoid censure by a supervisor) or they may unconsciously absorb the norms and standards of those around them. Research suggests that simply having workmates talk about ethical behaviour can reduce unethical conduct. In one study, when a workmate asked whether or not unethical behaviour was acceptable, people cheated less.¹⁴ A different study found that giving people the opportunity to have an ethics-based conversation with a colleague positively influenced the ethicality of their decisions.¹⁵

Leaders have a particularly strong influence on behaviour because of their status and their

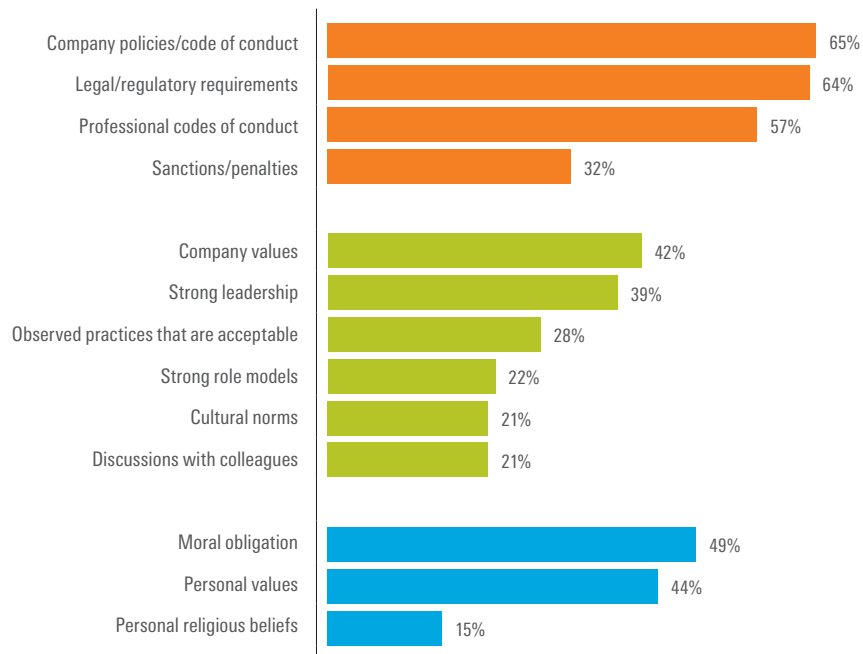
credibility as role models.¹⁶ They signal their expectations by what they reward, what they ignore and how they, themselves, behave.

INDIVIDUAL REGULATION OF ETHICAL BEHAVIOUR

Self-esteem is fundamental for psychological health,¹⁷ and failing to live up to our own standards of behaviour can undermine self-esteem by provoking guilt and self-censure. For this reason, most people are strongly motivated to act in accordance with their personal ethical standards.

Most people are strongly motivated to act **IN ACCORDANCE WITH THEIR PERSONAL ETHICAL STANDARDS**

FIGURE 1: PROPORTION OF RESPONDENTS WHO RANKED EACH ACTION IN THE TOP 5 MOST INFLUENTIAL ELEMENTS OF ETHICAL DECISION-MAKING.



WHY BEHAVE UNETHICALLY?

One argument frequently made by industry insiders is that ethical failures are caused by the wilful bad behaviour of a few ‘bad apples’. The chief executive of one global financial services firm commented, in response to the LIBOR manipulation scandal, ‘The lesson here is that the conduct of a small group of employees, or of even a single employee, can reflect badly on all of us.’¹⁸ A spokesman for another firm involved in the scandal ascribed his company’s involvement to a ‘limited number’ of employees acting on their own initiative.¹⁹ At an open forum in 2015, Bank of England Governor Mark Carney promised to ‘root out those bad apples’.²⁰

Blaming the industry’s ethical failures on a few ‘bad apples’ conveniently deflects attention from the cultural issues affecting the industry as a whole. Would it not be more useful to address the culture or the system that grows ‘bad apples’ and allows them to thrive? Many agree that positive cultural changes in the banking and financial services sector – including the difficult-to-tackle structural and social contributors – will have a better

and more permanent impact than simply addressing isolated cases of misconduct.

“Time and time again, we have seen firms blaming it on a few bad apples driving bad outcomes for consumers, rather than taking responsibility by looking more closely at their organisation and implementing the necessary changes to address the root cause of the problem.”

GREG MEDCRAFT,

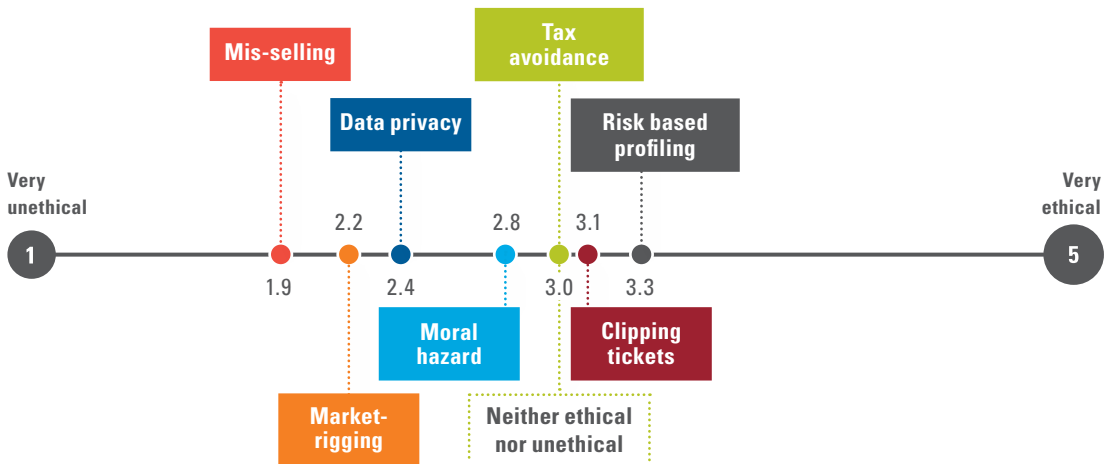
Chairman of the Australian Securities and Investments Commission.²¹

DO WE KNOWINGLY BEHAVE UNETHICALLY?

Research suggests that people are often unaware of the ethical implications of their actions.

The mis-selling of financial products is widely regarded as unethical, as demonstrated by our survey respondents in Figure 2. Yet over the past decade reports of mis-selling have been commonplace.

FIGURE 2: SURVEY RESPONDENTS AVERAGE ETHICAL RATINGS OF QUESTIONABLE INDUSTRY PRACTICES.



Since 2008, Hong Kong regulators have received over 29,000 complaints regarding the mis-selling of 'minibonds'.²² In the United Kingdom over a similar period, the Financial Ombudsman received more than 1 million complaints, which resulted in banks paying compensation of more than £24 billion.²³ Similar allegations have been made in other jurisdictions.^{24 25}

It seems unlikely that this many practitioners deliberately disregarded the ethical implications of their actions. A more plausible explanation is that an industry wide culture of tacit endorsement enabled wrongdoers to somehow justify their behaviour, irrespective of the ethical implications. In the following section, we examine in more detail how structural, social and individual factors specific to the banking and financial services industry can come together to foster a dysfunctional ethical culture – laying fertile ground for unethical behaviour.

"(I was) either the stupidest fraudster ever because I wrote everything down or there was an element of me that genuinely didn't think about it."

TOM HAYES

Speaking at his criminal trial for manipulation of LIBOR.²⁶



CASE STUDY:

MIS-SELLING OF PAYMENT PROTECTION INSURANCE (UNITED KINGDOM)

Payment Protection Insurance (PPI) is an insurance designed to protect consumers when an event affects their ability to meet their credit repayments. Typically, such events include injury, illness, involuntary unemployment and death. Over the past decade, more than 1 million complaints of mis-selling were lodged with the financial ombudsman in the United Kingdom. Complainants alleged that when they attempted to make a claim, they were advised that they were ineligible to claim on their policies due to exclusion clauses and administrative barriers not disclosed to them at the time of purchase.

In 2007, following the receipt of a super complaint²⁷ by the United Kingdom's Citizens Advice Bureau about what the Bureau named 'the Protection Racket', the Office of Fair Trading referred the supply of all individual PPI policies to the Competition Commission. The complaint asserted that the expensive and often ineffective insurance product was mis-sold by banks, providers and brokers and complaints about it had been mishandled on an industrial scale for many years.²⁸

Sales employees were offered significant incentives to sell PPI. Customers were often led to believe that they had to purchase the insurance in order to be granted credit, when that was not the case. PPI was also sold to customers who did not meet the criteria, who took out the insurance in good faith then found that they were ineligible to claim.

Since the Financial Services Authority introduced new regulations in 2011, banks and other companies have paid more than £24 billion in compensation for mis-selling PPI.^{29 30 31 32}

STRUCTURAL FACTORS - SYSTEMIC SUPPORT FOR UNETHICAL BEHAVIOUR

Laws and regulations can and do influence positive ethical decisions in the banking and financial services industry, but some structural factors encourage unethical behaviour. Compensation practices, for example, are frequently cited as contributing to ethical failures.³³

Complex and potentially ambiguous rules and regulations leave room for liberal interpretation. This is particularly relevant in the pressured, competitive environment of the banking and financial services industry.

COMPENSATION STRUCTURES: MORAL HAZARD

In recent times, high levels of remuneration (including significant bonuses) have been structured around short-term outcomes, without sufficient regard for the longer-term consequences. Many observers have commented that bankers in particular have been unfairly excessively rewarded, but in some cases seem exempt from appropriate penalties where it was shown that excessive risks were taken.

A recent report issued by the Bank of England stated that remuneration policies in the banking sector incentivised excessive risk-taking and contributed to the GFC.³⁴ The report acknowledged that since then, new rules³⁵ have aimed to better align employees' incentives with the long-term health of banks and the financial system, but views vary as to how effective these controversial changes will prove to be.

In a recent speech at the ASIC annual forum, chairman Greg Medcraft emphasised the

significant role that remuneration and incentives play as a driver of behaviour in the industry. He stressed how easily conflicts can arise where incentives reward a high-risk, short-term business strategy.³⁶

A survey of more than 1,200 financial professionals in the United States and United Kingdom found that 32% of respondents believed that compensation structures in place at their company (including bonuses) could incentivise employees to 'compromise their ethics' or break the law.³⁷

"[The day that performance bonuses are announced is] ... by far the most important event of your life for 12 months ... it dictates whether or not you can afford to send your kids to the school you'd planned ... It says whether you can afford to move house this year. It says whether you need to look for a new job ... We live in a world where one or two transactions can completely change our way of life. Personally, there were three days last year that will entirely decide my bonus - days when we won big deals. But the deals on those days could easily have gone the other way and ended in me getting nothing."

BANKER

From a global financial services firm.³⁸

Outcome-based financial incentives can also encourage a 'business decision' frame of mind, which as we will see can detract from the ethical implications of a course of action. The moral hazard present in compensation structures which incentivise high risk short term focused behaviour often converge with social factors in influencing behaviour, as people take their cues from the behaviour they see rewarded.



CASE STUDY: MIS-SELLING OF LEHMAN BROTHERS MINIBONDS (HONG KONG)

On 15 September 2008, Lehman Brothers Holdings Inc. – the fourth largest investment bank in the United States – filed a petition in the United States bankruptcy court. In Hong Kong, investors holding outstanding Lehman Brothers-related structured financial products (minibonds) suffered losses in excess of HK\$20 billion. Many of those affected were inexperienced investors who had been recommended the products by staff at their regular local bank.

In the wake of the Lehman Brothers collapse, the Hong Kong Monetary Authority, the Securities and Futures Commission and other bodies received more than 29,000 complaints, many asserting they had been mis-sold the products, specifically:

- Misrepresentation – that the products were wrongly presented as a low risk alternative to deposits and that the risks and complexity were not properly explained;
- Complexity – the products were too complex and risks disclosures were ineffective in alerting investors; and
- Suitability – that as a result of the above, and the failure of brokers and banks to do proper customer due diligence, inexperienced retail investors, including elderly and illiterate customers, were left holding products not suitable to their investment profile.^{39,40}

A settlement in 2011 saw many but not all retail investors compensated for between 70% and 93% of their losses.⁴¹ In Singapore, where nearly 10,000 people bought the same Lehman Brothers-related minibonds, the Monetary Authority found a number of institutions had mis-sold the products and banned ten local and foreign banks and financial institutions from selling structured notes to retail investors for up to two years.⁴²

REGULATORY GAPS

Regulatory gaps were identified as a contributing factor in the mis-selling of Lehman Brothers minibonds in Hong Kong. At the time, retail banks and investment firms were overseen by different regulatory authorities. Whilst this may have been appropriate when there was a clear demarcation between the products being sold, as Hong Kong banks became more involved in the securities market, the distinction between banking services and securities investments became blurred, creating regulatory 'grey areas'.⁴³

The Commerce Committee of New Zealand's Parliament identified a fragmented regulatory system as a contributing factor in the collapse of numerous finance companies amid claims of mis-selling and criminal misconduct. Its report identified overlapping responsibilities and inadequate funding among the various regulators, and said confused rules about advertising and disclosure left loopholes to be exploited.⁴⁴ Investigations into the rigging of the foreign exchange market in the United States found that a relative lack of monitoring made rigging more difficult to detect. As well, some activities had been exempted from federal oversight.⁴⁵

DISPROPORTIONATE CONSEQUENCES

Many believe that rewards for unethical behaviour in the financial services industry often far outweigh any potential negative consequences.

At an organisational level, large and significant corporations such as HBOS plc were 'too big to fail' in the GFC and as a result were bailed out by the government using taxpayer funds. Where charges against companies were eventually laid, in some instances they were settled by payment of fines; the companies were not necessarily required to admit wrongdoing. Furthermore, in some jurisdictions the fines were tax deductible.⁴⁶

TOO BIG TO FAIL

'Too big to fail' is the notion that certain organisations are so economically vital, in particular large global financial services firms, that their failure would cause serious harm to the global economy necessitating (often large scale) government financial assistance.

The concept was central to the GFC, when various governments including the United States and United Kingdom paid out many billions of dollars to save companies including HBOS, Lloyds, AIG, Bank of America, and General Motors from financial failure.

These government bailouts were the subject of fierce debate, with opponents arguing that organisations benefiting from the 'too big to fail' safety net took on high risk high return positions – ultimately leading to their financial downfall, with many of those responsible continuing to receive large bonus payments at the expense of tax payer-funded rescue packages.

SOCIAL FACTORS – CULTURAL DYNAMICS

Experts say that the social environment or cultural dynamics of an industry can also contribute to the unconscious 'fading' of ethical considerations. In a study of the behaviour of vehicle emission testing inspectors, psychologists found that when they worked across different facilities (i.e. switching job locations) inspectors adjusted their level of unethical behaviour almost immediately to conform to the local organisational norm.⁴⁷

A great deal has been written about the cultural dynamics of the banking and financial services industry, in particular the lack of diversity and competitiveness. In this section we discuss how these social factors can affect ethical behaviour and decision-making.

COMPETITIVE PRESSURE

Many of the competitive pressures of the industry are met with innovation and hard work, but innovation involves risk and does not always deliver a predictable and sustainable flow of earnings. Hard work provides little real competitive advantage in an environment where long hours are standard. Under these circumstances, practices that provide a predictable and sustainable flow of earnings are soon considered to be essential, even if their ethical status is dubious.



CASE STUDY:

FOREIGN EXCHANGE MARKET RIGGING (UNITED KINGDOM, UNITED STATES, ASIA AND SWITZERLAND)

In 2013, rigging of the foreign exchange (forex) market was detected the United Kingdom, United States, Asia and Switzerland. Market regulators investigated claims that currency dealers in these countries had been rigging the WM/Reuters rates by colluding in internet chat rooms and putting trades through before and during the 60-second period in which the benchmark rates are set. According to whistle-blowers, currency dealers were engaging in this behaviour on a daily basis for at least ten years.⁴⁸ By 2014, more than 30 forex employees had been suspended, placed on leave or fired, and four major banks had pleaded guilty to conspiring to rig a financial market. Those four banks and two others were fined nearly US\$6 billion for their roles in the rate fixing. A single trader was arrested in connection to the market rigging in 2014, and subsequently bailed without charge. To date, no other arrests appear to have been made or convictions recorded.⁴⁹



CASE STUDY: THE FAILURE OF HBOS PLC (UNITED KINGDOM)

HBOS plc was formed in 2001 by a merger of Halifax plc and the Bank of Scotland. The firm experienced strong growth and returns initially, but an inexperienced board failed to instil a culture that balanced risk and return appropriately, leading to an excessive focus on market share, asset growth and short-term profitability. In 2008, affected by the GFC, the firm's liquidity position deteriorated and a takeover was negotiated with Lloyds Banking Group. Shortly afterwards, the government announced a bailout of the group of up to £17 billion. From 2004 onwards, HBOS plc had been subject to review by a supervision team from the Financial Services Authority (FSA). For a significant portion of this review period, HBOS chief executive James Crosby was also a member of the FSA board. To date only one person has been held officially accountable for the firm's failure. Peter Cummings, the former head of the corporate division, was fined £500,000 by the FSA in 2012 and banned from working in the banking industry for life.^{50 51}

company collapses, for example, described the financial community leading up to the finance company collapses as 'a culture in which anything that was not illegal was right'.⁵² Similar comments were made by the chief executive of a major United Kingdom bank in the wake of the LIBOR scandal: 'Pretty much anything you could do to increase the revenue of your organization appeared legitimate'.⁵³

A relationship between the perceived necessity and ethicality of various industry practices was also evident in the results of our survey. As illustrated in Figure 3 on page 22, the more necessary the practices were rated by respondents, the more ethical they considered the practices to be. When an action is seen as necessary, those who engage in it are less likely to question the rightness or wrongness of what they do and more likely to reject such questions from others.

LACK OF DIVERSITY

The banking and financial services industry has historically lacked diversity, especially at senior management level. Industry and political spokespeople in the United Kingdom have recently sought to tackle a gender imbalance after acknowledgement that the 'laddish bank culture' was at least a contributing factor to some recent industry scandals.⁵⁴ Women made up only 25.7% of board members and 22.3% of managers at banks across the United Kingdom, Europe and United States. In 2011 in America, 81% of managers in the financial services sector were white, with African-Americans accounting for only 2.7% of senior managers.⁵⁵ When an organisation or profession lacks diversity, there is more pressure to conform. Social norms reflecting the shared values and beliefs of the group are rapidly established and strongly emphasised in a process popularly referred to as 'groupthink'.

A PERSON WHO BELIEVES THAT A PRACTICE is necessary for themselves and their organisation to succeed HAS A VESTED INTEREST IN FRAMING THAT PRACTICE AS ETHICAL.

To do otherwise would be to acknowledge that one is behaving unethically and suffer the associated guilt and self-censure. One submission to the parliamentary committee that investigated New Zealand finance



CASE STUDY: COLLAPSE OF FINANCE COMPANIES (NEW ZEALAND)

Between 2006 and 2012, 67 New Zealand finance companies collapsed or entered into debt moratoriums, resulting in over 150,000 deposit holders losing in excess of NZ\$3 billion.⁵⁶ In the decade leading up to the collapses, finance companies had rapidly increased their lending in terms of both size and risk following a period of growth in the New Zealand property sector. Difficult economic conditions brought about by the GFC and a run on funds (set off by the failure of a small number⁵⁷ of finance companies, initially) left many finance companies without sufficient liquidity.⁵⁸ An investigation by the Commerce Committee of New Zealand's Parliament⁵⁹ reported the following as contributing factors in the collapses:

- Poor governance and management, specifically inadequate management of risk.
- Criminal misconduct, ranging from deliberate misrepresentation of risks and non-disclosure of significant lending to related parties, to outright fraud and Ponzi-style scams.
- Deficiencies in disclosure, advice and investors' understanding, noting that the information and advice provided to investors was frequently poor, with investors unaware of advisers' interest in promoting certain products and poorly informed of the associated risks.
- Inadequate supervision in a framework that was fragmented and insufficiently rigorous.⁶⁰

In efforts to reassure investors and stabilise the banking and financial services sector, the New Zealand Government bailed out nine finance companies between 2008 and 2011 at a cost of around NZ\$2 billion⁶¹. By 2015, 20 company officers had been convicted of a range of offences; at least 4 received prison sentences. Judgements against company directors and auditors in numerous civil⁶² actions exceeded NZ\$150 million.

In the 2013 foreign exchange markets scandal, this kind of tribalism was apparent in chat room exchanges between traders, who referred to themselves as 'the cartel', 'the mafia' and 'the three musketeers'. One trader, in discussing a prospective new member, asked 'is he gonna protect us like we protect each other'.⁶³ Another in a different chat room declared, 'we all die together'.⁶⁴ Groupthink increases the potential for unethical behaviour by encouraging group members to ignore or rationalise information that contradicts group decisions or goals.⁶⁵

Social environments characterised by groupthink present a major obstacle to challenging entrenched unethical behaviour. In the fallout from the LIBOR scandal, for example, traders at UBS reported feeling pressured by managers to manipulate the market.⁶⁶ In these environments, whistleblowers can often pay a heavy social and emotional price for disrupting the smooth operation of the group. Carmen Segarra, appointed as the New York Federal Reserve's regulator to Goldman Sachs, alleges that she was fired after refusing to water down her concerns about conflicts of interest at the company;⁶⁷ Goldman Sachs claims that she was fired for performance related issues. Paul Moore, former head of group regulatory risk at HBOS plc, alleges that he was fired after warning the bank's board about risky sales strategies.⁶⁸ As one participant in a report on the banking industry noted, it is almost always going to be a career-limiting move to put a stop to a profitable practice.⁶⁹

INDIVIDUAL FACTORS – MENTAL SHORT CUTS AND BIASES

The human brain's ability to absorb and process information is remarkable, but it has limits. In order to function we need mental shortcuts that allow us to make some decisions quickly and easily. The information-rich, fast-paced environment of the banking and financial services industry is particularly fertile ground for these mental shortcuts, or heuristics, as psychologists call them.

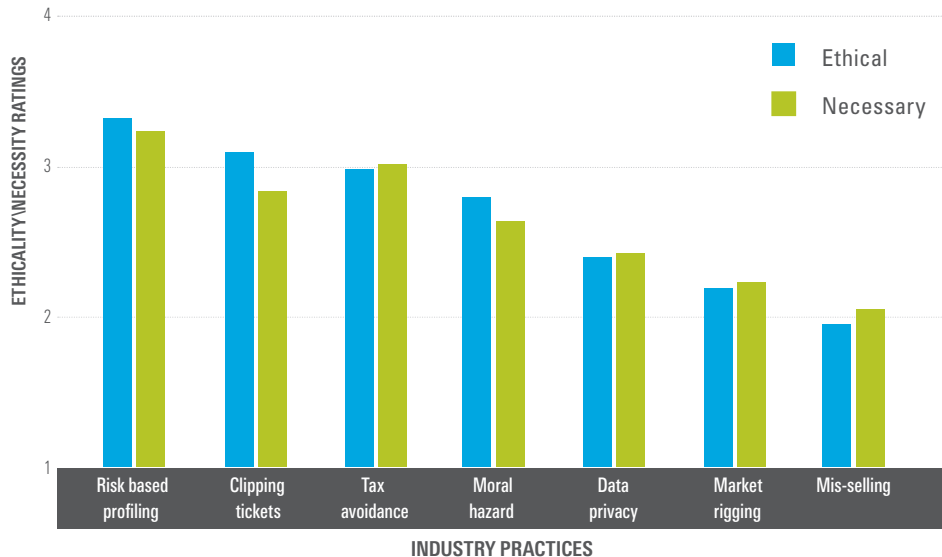


FIGURE 3: PERCEIVED ETHICALITY AND NECESSITY OF QUESTIONABLE BANKING AND FINANCIAL SERVICES INDUSTRY PRACTICES, WHERE 1 IS VERY UNETHICAL/UNNECESSARY AND 5 IS VERY ETHICAL/CRUCIAL.

When people use heuristics to make a decision, rather than examining all of the available information, they simplify the task by drawing on unconscious knowledge. Unconscious knowledge is accumulated over the course of a person's life and stored in their long-term memory, making it difficult to contradict.

Heuristics are an ingenious adaptation, but they open decision-making up to bias and unrecognised motivations. **Unconscious biases are judgements that do not reflect the information available. They don't accurately represent the challenges confronting us, and can lead to inappropriate judgements about people, problems and situations.**

We now discuss three common heuristics that are relevant to decision-making in the banking and financial services industry.

CONFIRMATION BIAS

Confirmation bias, or tunnel vision as it is informally known, is a tendency to seek out and assign more weight to evidence that confirms a preferred conclusion, and ignore or under-weigh evidence that could oppose it. The HBOS plc board's failure to challenge management on the information they were providing about the firm's position is an example of 'only seeing what you want to see', and was identified as a contributing factor in the collapse of the bank.⁷⁰ In 2014, the Australian Prudential Regulatory Authority identified similar 'lax and unquestioning oversight' as having contributed to irregular foreign currency trading at National Australia Bank.



CASE STUDY:

NATIONAL AUSTRALIA BANK IRREGULAR CURRENCY OPTIONS TRADING (AUSTRALIA)

In 2003, four foreign exchange traders at the National Australia Bank (NAB) incurred significant losses while engaging in unauthorised trading. The traders positioned the NAB's foreign currency options portfolio expecting the 2003 falls in the US dollar to reverse. They didn't close their positions as the market moved against them, but chose to cover them up instead. For months the situation worsened unchecked before they were finally discovered. The Australian Prudential Regulatory Authority (APRA) was informed of the irregular activity on the currency options desk on 13 January 2004, immediately before the NAB released its first statement about the case to the Australian Securities Exchange. At that time the NAB announced a loss of AU\$180 million from unauthorised dealing within its currency options business. The NAB made a further announcement on 27 January in which it restated the size of the losses to be AU\$360 million. The chief executive and board chairman of the bank resigned and eight people, including three senior managers, were dismissed. The Australian Securities and Investments Commission brought charges against the four rogue traders and all were found guilty and given prison sentences.⁷¹

AVAILABILITY BIAS

Availability bias is the process by which more readily available information is given greater preference in making decisions. As a result of this process, decisions are often based on information that is recent rather than relevant, because it is easier to remember.

A situation that arose in the United States immediately following the September 11 terrorist attacks provides an example. Due to a heightened awareness of the risks of flying, a reported 1.4 million people cancelled flights, many of them opting to travel by car instead, despite the statistical truth that air travel is significantly safer than travelling by car.⁷⁴ With September 11 fresh in their minds, the more relevant information – the relative safety of flying – was overridden. In a tragic irony, the increased number of people on the roads in the three months after the attacks led to a significant increase in traffic fatalities during that period.⁷⁵

Availability bias interacts with social factors in decision-making. The easier it is to think of people who have engaged in an act, the more likely we are to assume that the act is ethical.⁷⁶ Put simply, if everyone is doing it, it must be right.

This has obvious implications in organisations where social norms endorse unethical practices.

FRAMING BIAS

When faced with a decision, people respond according to the context of the situation they are in, or the manner in which the information

ETHICS, TRUST AND THE FINTECH REVOLUTION

In a recent survey⁷², global participants were asked about their trust in businesses across various industries. For the fifth year in a row, financial services was ranked as the least trusted of the eight industries surveyed. In a different survey of millennials² carried out in the United States⁷³, 73% of respondents said that they were more excited by a financial services offering from Google, Apple, Amazon, PayPal or Square than from a traditional established bank.

When combined with the emergence of often lightly regulated and innovative fintech competitors, this research supports the notion that unless traditional financial services firms put an end to industry scandal and rebuild consumer trust, they run the very real risk of losing business to more agile and trusted technology brands such as Paypal, Amazon and Google.

² those born between 1981 and 2000

is presented to them. Is the situation competitive or cooperative, for example, professional or informal, business or ethical? Decision framing refers to the way cues in the environment cause people to focus attention on certain aspects of a situation while 'fading' others⁷⁷ – for example a focus on the purely economic aspects of a situation at the expense of ethical considerations.

These effects can be particularly powerful in a corporate setting, where research has shown that the context in which people operate can significantly influence their behaviour. In several experimental studies, researchers found that when subjects focused on the economic aspects of a situation, a 'business frame' was triggered which led to self-interested evaluations of costs and benefits at the expense of ethical considerations.^{78 79 80}

JUSTIFICATION

In the previous section we focused on factors that could lead to unconscious unethical conduct. In this section we discuss how people rationalise or disengage from their unethical behaviour after the fact, with the same goal of preserving their view of themselves as 'good'.



CASE STUDY: MANIPULATION OF LIBOR (UNITED KINGDOM & UNITED STATES)

The London Inter-Bank Offered Rate (LIBOR) is a crucial interest rate, used as a benchmark globally, which impacts trillions of dollars in financial transactions. LIBOR is based on daily submissions from a number of international banks and is administered by the British Bankers' Association. It indicates the average cost to banks of unsecured borrowing for a given currency and time period.

In 2009, investigations into LIBOR rate-setting by United Kingdom regulators, including the Financial Services Authority, exposed industry-wide manipulation. Many major banks were found to have falsely inflated or deflated their rates over a period of years in order to profit from trades or to improve perceptions of their creditworthiness. A special adviser to the secretary general of the Organization for Economic and Cooperation and Development said, 'we will never know the amounts of money involved, but it has to be the biggest financial fraud of all time.'⁸²

A report prepared for the United Kingdom's Treasury found that banks and individuals had significant incentive to manipulate the rates. Regulation and oversight of rate-setting was undermined by a fundamental conflict of interests, as the same banks who stood to gain by manipulation of the rates were responsible for supervising the submission process. This overlap, the report suggested, may have prevented those responsible for enforcing the benchmark submission standards from doing so objectively or independently.⁸³ There are several investigations still underway, but to date regulators in the United States, the United Kingdom and the European Union have fined banks more than \$10 billion, more than 100 traders or brokers have been fired or suspended and several executives have been forced to resign. The list of financial institutions to receive fines includes Citigroup, Royal Bank of Scotland, Deutsche Bank, JPMorgan, RP Martin, Lloyds and Rabobank. Up to 20 people have been criminally charged, with two convictions and three guilty pleas already recorded in the United States, four convictions and six acquittals in the UK, and more trials still underway.^{84 85 86}

The practice was tried and tested, it was so endemic within the bank (UBS), I just thought ... this can't be a big issue because everybody knows about it ... (it was) such an open secret.

TOM HAYES

The first person convicted in the United Kingdom for the manipulation of LIBOR, speaking at his trial.⁸¹

MOTIVATED BLINDNESS

Motivated blindness is a powerful social phenomenon in which people overlook unethical behaviour when it's in their best interests to do so. It's when we don't recognize the facts in front of us because to do so would be inconvenient.

We all want to believe that we are competent, and that desire extends to moral competence. When we work for an organisation, an element of our identity is linked to how we perceive that organisation. This often causes us to invest in believing, and having others believe, that our place of work is morally competent.

This form of in-group favouritism or bias can lead people to think that the unethical actions they observe are more common in the broader society than in their own circles. A survey of financial services professionals from the United States and United Kingdom found that while 47% of those surveyed believed that their competitors had engaged in unethical or illegal activity in order to get ahead, only 23% believed the same of their colleagues⁸⁷. As illustrated in Figure 4, this effect was also evident in our survey results. Respondents consistently thought that ethically questionable practices were more prevalent in their country at large than in their own companies.

THE END JUSTIFIES THE MEANS

When using this rationalisation people argue to themselves or others that their actions are justified by good outcomes.

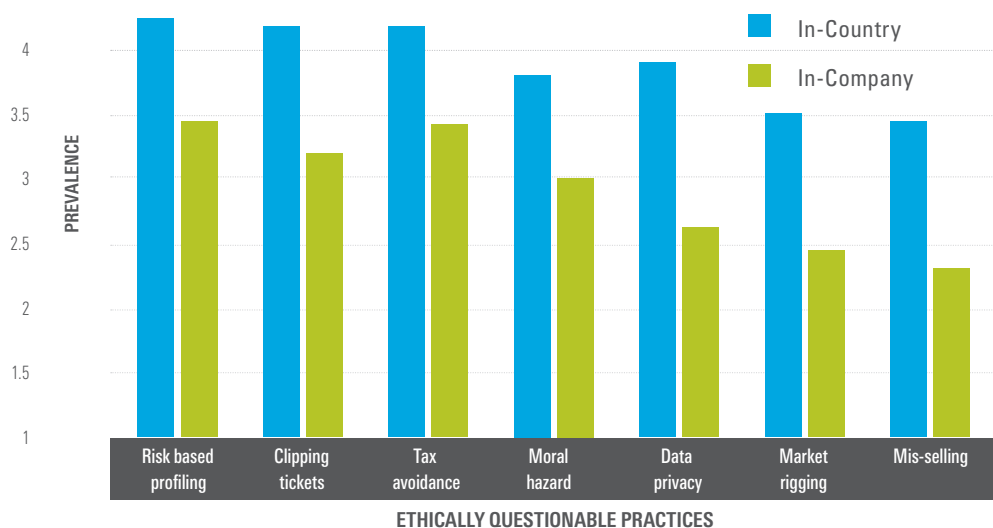
*'That was the problem with money: What people did with it had consequences, but they were so remote from the original action that the mind never connected the one with the other.'*⁸⁸

MICHAEL LEWIS

The Big Short: Inside the Doomsday Machine

This type of reasoning appears to be particularly common in the banking and financial services industry due to the often significant incentives on offer for those who succeed. People who use this rationalisation often further justify their actions by convincing themselves that their actions serve a higher social purpose. The following extract is from a personal email written by a trader in the United States. He was ultimately convicted for actions that led to large losses during the GFC:

FIGURE 4: COMPARISON BETWEEN PERCEIVED PREVALENCE OF PRACTICES IN RESPONDENTS' COUNTRIES AND THEIR PLACE OF WORK, WHERE 1 IS VERY UNCOMMON AND 5 IS VERY COMMON.



"... not feeling too guilty about this, the real purpose of my job is to make capital markets more efficient and ultimately provide the U.S. consumer with more efficient ways to leverage and finance himself, so there is a humble, noble and ethical reason for my job."⁸⁹

'We help companies to grow by helping them to raise capital. Companies that grow create wealth. This, in turn, allows people to have jobs that create more growth and more wealth. It's a virtuous cycle. We have a social purpose.'⁹⁰

LLOYD BLANKFIEN,
Chief executive of Goldman Sachs

EUPHEMISTIC LANGUAGE

Euphemistic language involves the use of a word or phrase with comparatively

favourable associations as a substitute for something harsher or more offensive (but also more precise). There is a great deal of euphemistic language used in the banking and financial services industry. The Lehman Brothers retail investment products sold in Hong Kong and Singapore under the name 'minibonds' gave many investors a false sense of security, as the products were not strictly a form of bond, but rather highly complex first-to-default, credit-linked notes.⁹¹

Euphemisms such as 'equity retreat' for stock market crash, and 'externalities' for harms done to uninvolved parties, allow people to distance themselves from the repercussions of their actions and continue to engage in practices without acknowledging their ethical implications.⁹²

ETHICS AND TECHNOLOGICAL DISRUPTION

The banking and financial services industry is ripe for technological disruption. This type of evolution will have both positive and negative implications in the field of ethics.

Consider the potential impact of distributed ledgers such as the blockchain – the technology underlying bitcoin – on banks and insurance companies. This technology promises automated and near-instant settlement and payment, and creates an immutable, transparent record of all transactions. The decentralised nature of a blockchain means that data is spread across a network of computers rather than being held by a single, central entity. Automation such as the blockchain vastly reduces the risk of human error, including ethical failure.

Similar principles apply to alternative financing, which is undergoing rapid growth. The United Kingdom's alternative finance sector issued £3.2 billion worth of loans investments and donations in 2015, up 84% on the previous year.⁹³ Disruptive practices such as peer-to-peer lending and crowdfunding, although not without their own challenges, enable small businesses and individuals to bypass traditional financial institutions altogether.

However, technology will also give rise to new concerns. One such ethical hotspot is data privacy, security and the use of data for predictive analysis. Another is the impact of automation and robotics on the workforce. Organisations that can effectively manage these risks stand to gain the trust of their customers and with it a competitive advantage.

WHERE TO FROM HERE?

Individual motivation to live up to one's own standards is the strongest determinant of ethical behaviour, but failing to live up to one's own standards is sometimes not a conscious choice. Individual standards can be shaped or obscured by structural and social factors.

The challenge lies in ensuring that ethical standards are given their appropriate place in decision-making and action. Organisations need to address contributing factors at the structural, social and individual levels. As illustrated in Figure 5, this approach is endorsed by our survey respondents, who recommended an array of potential actions as effective for encouraging ethical behaviour.

According to the United States Ethics Resource Center's National Business

Ethics Survey (2012), multi-level interventions:

- reduce the pressure felt to compromise standards,
- reduce observed rates of misconduct,
- increase the reporting of misconduct, and
- reduce retaliation against those who report misconduct.

External regulation plays a central role in the banking and financial services industry but cannot succeed in isolation. Our recommendations are intended for discussion purposes, to promote industry-wide debate on interventions that will encourage ethical behaviour by individuals and teams and reduce the risks of ethical failures, both deliberate and unintended.

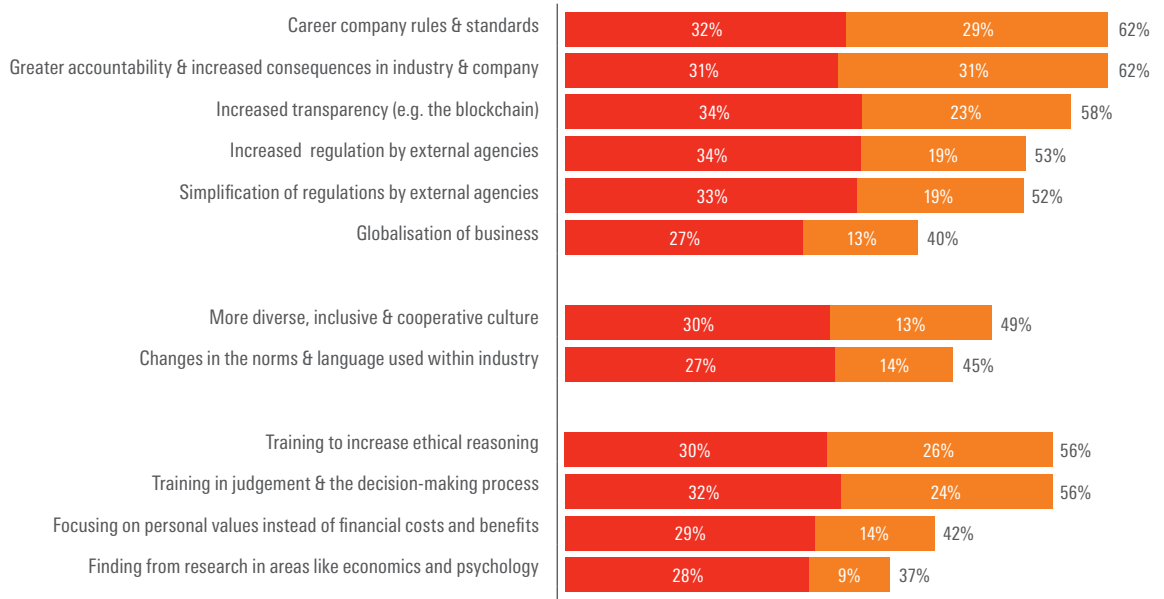


FIGURE 5 PROPORTION OF RESPONDENTS WHO RATED EACH ACTION AS MODERATELY OR VERY EFFECTIVE IN IMPROVING RATES OF ETHICAL BEHAVIOUR.

STRUCTURAL RECOMMENDATIONS

1. Realignment of incentives

In the design of remuneration structures, what gets measured gets done: measure and reward the behaviour you want to see more of. In financial services, the measure is usually financial gain – no matter how it is achieved.

Ethical considerations, including client satisfaction, should be integrated into decision-making and measured and considered when remuneration is calculated and incentives awarded.

Many banking organisation carry out client surveys and ratings of employees by their leaders and peers. Such measures can assess whether an employees' performance is ethical and in the organisation's best long-term interests, and whether they treat their clients and peers with respect.

We recommend the continued and extended use of such assessments across the industry to inform compensation practices. Ethics, risk and client satisfaction should be considered as well as profits in the awarding of bonuses. Practices such as compensation disclosure, consideration of shareholder input, risk management, and including clawback and deferral provisions in contracts should be explored in an effort to curb unethical behaviour and move forward in this divisive area.

2. Principled reasoning

Even under ideal circumstances, we cannot accurately predict all of the possible outcomes of a decision.⁹⁴ This effect is exacerbated in the banking and financial services sector, in which employees are often less motivated to consider the long-term and non-financial consequences of their choices.

Principled reasoning addresses these concerns by providing a clear set of principles to guide decision-making. The principles often form part of an organisation's code of conduct. They are of most value when leaders at all levels model them and make it clear that they are non-negotiable. Their success in driving cultural change depends on leadership's ability to translate the values on paper into behaviours that can be monitored and measured.

Specific guiding values and principles could include:

- Ethical vs legal: a clear definition of what it means to be ethical as opposed to legal in specific situations and for different tasks.
- Client focus: an expectation that the client's interests are clearly understood and are not compromised in the pursuit of company or personal gain. An acknowledgement that client trust underpins reputation and is a source of competitive advantage. Explicitly state: 'we should never win at our client's expense'.
- Institutional integrity: always do business with integrity.
- Exercise good judgement: when in doubt seek guidance.
- Report unethical conduct: an expectation that employees challenge peers and leaders whose actions appear to violate the non-negotiables. A statement that employees should be able to do so without fear of recrimination and in expectation of organisational support.

Principled reasoning will challenge leaders and their teams to identify options that are both aligned with the organisational values and profitable.

3. Harness the power of analytics

As stated earlier in this section, what gets measured gets done. This is as applicable to ethics as it is to the number of trades and open positions an organisation holds. The accurate

measurement and reporting of ethical key performance indicators (EKPIs) provides leaders with the information they need to assess their ethical climate, identify and manage the risks and where necessary take corrective action.

To be effective, EKPIs should link directly to an ethical target. Take one example discussed earlier: putting the customer's needs first. Logical EKPIs in this instance might be the type and number of customer complaints received, the type and number of regulatory sanctions received, and the nature of comments made on mainstream or social media.

The use of data analytics is becoming increasingly popular in this area. Analytics can also be used to identify anomalies in trading data or as a predictive tool to pinpoint areas of an organisation that may be at greater risk of non-compliance.

SOCIAL RECOMMENDATIONS

4. Diversity and inclusion

The lack of diversity in many organisations in the banking and financial services industry contributes to a culture of loyalty and groupthink. This can discourage the reporting of misconduct by colleagues and industry insiders. Increasing diversity in the industry presents a long-term challenge, but it begins with strong leaders who promote inclusion.

In 2015 we released as part of our future[inc] thought leadership series *Fast Forward: Leading In A Brave New World Of Diversity*. This paper highlighted six signature traits of best-in-class inclusive leaders.⁹⁵

- Commitment – because staying the course is hard
- Courage – because talking about imperfections involves personal risk taking
- Collaboration – because a diverse thinking team is greater than the sum of its parts

- Cultural intelligence – because not everyone sees the world through the same cultural frame
- Curiosity – because tapping into different thinking enables growth
- Cognisance – because bias is a leader's Achilles heel

Inclusive leaders will develop processes that enable divergent views, including ethical considerations, in their everyday interactions and discussions. In this context, team members are more likely to call out violations of ethical standards and support each other in ethical decision making.⁹⁶

What's more, teams that can discuss divergent ideas and agree priorities without conflict are more innovative and more productive than homogenous teams that agree quickly without constructive discussion.

5. Examine euphemisms

The use of simplified language, acronyms and jargon is expected in any industry. In an industry as complex as banking and financial services it is inevitable. However, the use of euphemistic language can occasionally allow people to distance themselves from the ethical implications of their actions. As a rule of thumb it should be called out and where possible avoided.

It may seem a small step, but by highlighting the use of euphemistic language, and replacing euphemisms with their plain English equivalent, organisational leaders will effect positive change. Plain English training courses and writing guides are widely available.

INDIVIDUAL RECOMMENDATIONS

6. Ethical moments

We introduced decision framing earlier in the paper – specifically we looked at

the 'business frame', which promotes cost benefits analysis over ethical considerations. But decision framing can be used to support rather than undermine ethical behaviour. A simple technique is to have 'ethical moments' at the beginning of all meetings in order to create an 'ethical frame'. An ethical moment is a short conversation about ethical issues. It may relate to imminent decisions or to examples from other sources, such as newspapers or industry contacts. As we saw earlier, when employees talk about ethics they carry this awareness into their job function. Several studies have found that when people have adopted an ethical decision frame they behave ethically regardless of external rules and punishment.^{97 98 99}

Ethical moments are based on 'safety moments', which have been used successfully in mining and other heavy industries. Numerous resources provide guidance on the effective use of safety moments, many of which could be adapted to implement ethical moments in banking and financial services settings.

7. Build a framework

Sometimes simple is best, and one simple but effective method used in other industries is the application of an ethical decision-making framework to help employees identify and navigate ethical dilemmas. Such frameworks encourage the conscious consideration of ethics when making decisions. They provide structure, and help people to clarify the facts, identify ethical issues and associated risks, and assess available courses of action against organisational values and policies, the law and any other applicable standards. To ensure relevance and buy-in, leaders should develop a framework tailored to their organisation's specific needs.

CONCLUSION

In the wake of the GFC, scandals continue to rock the banking and financial services industry. The response is often to weed out the 'bad apples' and reform external regulation.

As we have shown, a number of factors influence the extent to which we are conscious of ethical considerations. We are affected by the need to take mental shortcuts in a complex and demanding environment. Social pressures can blind us to all but the fiscal elements of a situation. These individual and social factors are often reinforced by the lure of large financial incentives for actions that benefit the bottom line.

Any attempt to improve ethical behaviour in the banking and financial services industry will only be successful if all of the factors that influence practitioners in the performance of their roles – both conscious and unconscious – are recognised and addressed. We also need to recognise both the positive potential and the risks presented by technological disruption. The recommendations in this paper are intended to promote debate amongst key industry stakeholders. Our intention is to challenge organisations in the industry to develop comprehensive, evidence-based ethics programs that recognise their industry's unique dynamics and offer a realistic opportunity for genuine cultural change.

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