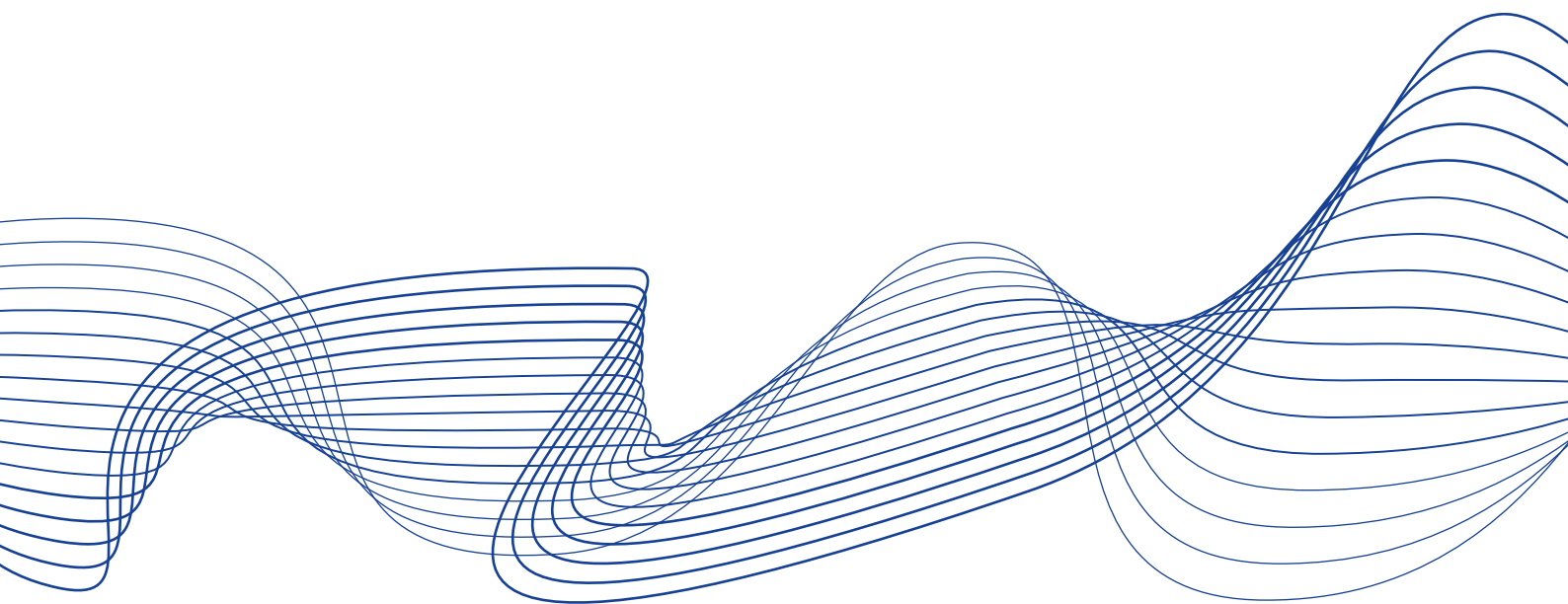


**Report on misconduct risk  
in the banking sector**  
June 2015



**ESRB**  
European Systemic Risk Board  
European System of Financial Supervision

# Contents

Executive summary	3
<b>Section 1</b> Introduction	4
<b>Section 2</b> Costs to society and impact on confidence	6
<b>Section 3</b> Prevention of misconduct	9
<b>Section 4</b> Penalties imposed in misconduct cases and consequences for financial stability	12
<b>Section 5</b> Capital covering misconduct risk	17
<b>Section 6</b> Business restrictions	19
<b>Section 7</b> Coordination of measures to address misconduct	21
<b>Section 8</b> Possible next steps	23

## Executive summary

This report analyses misconduct risk in the banking sector from a macroprudential perspective. Misconduct risk refers to risks attached to the way in which a firm and its staff conduct themselves. As such, it includes how customers and investors are treated, mis-selling of financial products, violation of rules and manipulation of markets. Although misconduct risk is typically firm-specific, two dimensions of the potential systemic impact of misconduct by EU banks are identified in this report.

First, misconduct at banks imposes costs on society. In particular, it may damage confidence in the financial system, which has been impaired since the emergence of the crisis and is a vital element for the proper functioning of the system. This could discourage users of financial services from utilising the system. Thus, it should be prevented by all means and firmly condemned.

Second, while financial and other penalties applied in misconduct cases rightly serve as a correcting mechanism, in certain cases, they may themselves entail systemic risks that could impose costs on users of the financial system.

Misconduct and related penalties are typically tail events. They can create uncertainty about the business model, solvency and profitability of banks. Misconduct issues often arise across markets and also in systemically important banks. Therefore, a large part of the sector can be affected, leaving it more vulnerable to other shocks. In addition, misconduct costs may rise following a period of crisis – as is currently the case – and, as such, may have a procyclical impact.

The consequences of misconduct could be a withdrawal from financial markets and activities by a bank, either forced or on a voluntary basis, such that the functioning of a particular market is impaired, leading to a direct loss of financial services for the end user.

This report highlights a number of actions that are required to address the systemic risks mentioned:

- (a) Prevent misconduct at all levels by requiring banks to adopt behaviours, practices and internal control and compliance mechanisms that are conducive to limiting the opportunities for misconduct.
- (b) Explore extending the Legal Entity Identifier (LEI) scheme to a larger range of counterparties.
- (c) Ensure that Supervisory Review and Evaluation Process (SREP) assessments take into consideration the systemic impact of potential misconduct. Where relevant, competent authorities can apply Pillar 2 measures, such as requiring the strengthening of internal governance and compliance or applying capital add-ons to cover systemic misconduct risk.
- (d) Promote improved coordination and transparency between the members of international bodies, such as the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), by establishing a framework for coordination that embraces best practices in banking and principles to ensure that any spillover effects associated with enforcement and sanctioning actions are well managed.
- (e) Include potential misconduct risks adequately in future stress tests. The European Banking Authority (EBA) should, in cooperation with the European Systemic Risk Board (ESRB), devise a minimum methodology for banks to apply when calculating the potential cost of misconduct under stress situations.

## Section 1 Introduction

The number and scale of misconduct cases recently observed, as well as the related penalties and redress costs, means that misconduct issues may have the potential to create systemic risks.

First, misconduct by banks imposes costs on society at large. For example, mis-selling of financial products leads to a suboptimal allocation of investments and risks (as witnessed in the years preceding the financial crisis) and manipulation of financial markets distorts the proper functioning of these markets, allowing banks to profit from undue rents. Misconduct related to tax evasion has a direct impact on state revenues and misconduct related to money laundering undermine the efforts of states to enhance global security.

Second, when misconduct is finally revealed, banks can be faced with severe penalties (financial and other) and redress costs, and this may have consequences for financial stability. Both providers and users of financial services alike may react to the prospect of misconduct risk by inflicting costs on the wider financial system. In the light of this, the ESRB examines in this report the systemic implications of misconduct risk in the banking sector.

More specifically, the key objectives of the report are to:

- (a) determine the likely scale of the macroprudential risks arising from misconduct issues at banks, and, in particular, assess which kinds of misconduct are most significant in terms of the potential impact on financial stability;
- (b) assess the potential systemic impact of financial and non-financial costs applied to banks;
- (c) consider what steps could be taken at the domestic, EU and international levels to prevent and mitigate misconduct at banks and the impact of major sanctions on financial stability, approaching the issue from a macroprudential perspective;
- (d) explore what steps could be taken at the EU or international level to promote greater coordination among different national authorities in order to ensure consistent approaches and appropriate contingency planning, as one option at disposal of authorities to address misconduct.

Although misconduct can also be observed in other parts of the financial system, this report focuses on banks. There are two main reasons for this. First, banks, with their central position in the financial system and wider economy, generally pose the greatest systemic risk. Second, banks are at present the financial institutions facing the most significant misconduct issues.

Broadly put, conduct risk refers to risks attached to the way in which a firm and its staff conduct themselves, and to how customers and investors are treated. This report deals with the consequences of “misconduct” by banks and therefore uses the term “misconduct risk”. From a prudential supervision perspective, conduct risk is a subset of operational risk<sup>1</sup>. However, from a conduct supervision perspective, conduct risk is broader as it includes the risks to which banks may be exposed as a result of their poor business conduct, as well as the risks to which such conduct exposes their customers.

Presently, a number of definitions of misconduct risk are in common use. These vary according to the causes and the impact emphasised. Misconduct is normally associated with wilful or intentional disregard of laws, ethics or internal governance and controls. It is more likely where internal processes and governance are inadequate. It can take place at the level of an individual employee, an institution,

---

<sup>1</sup> The Capital Requirements Regulation (Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013, OJ L 176/1) defines operational risk as “the risk of loss resulting from inadequate or failed internal processes, people and systems or external events, and includes legal risk”. A recent stock-taking exercise on EU jurisdictions performed by the EBA confirmed that this risk most often falls under the “Clients, Products & Business Practices” and “Internal fraud” categories of the Loss event type classification provided by Article 324 of the Capital Requirements Regulation (CRR).

or across the entire sector. The impact is detrimental to customers, investors, other stakeholders, society at large and the bank itself. The issue is so broad in scope that a single, narrow definition neither seems possible nor desirable.

Considering recent cases, the following non-exhaustive list of the main types of misconduct can be identified:

- (a) mis-selling of financial products to retail customers, for instance the payment protection insurance mis-sold by UK banks;
- (b) mis-selling of financial products to professional clients, for instance the US subprime mortgage-backed securities mis-sold by US banks;
- (c) violation of national and international rules and regulations (tax rules, anti-money laundering rules, anti-terrorism rules, economic sanctions, etc.), for instance EU banks breaking US sanctions against trade with Sudan, Iran and Cuba;
- (d) manipulation of financial markets, for instance the manipulation of LIBOR rates and foreign exchange benchmark rates by several EU banks.

This report fully recognises the extent of the costs that misconduct imposes on society; clearly, it should be prevented. The specific macroprudential concerns considered in this report, i.e. vis-à-vis the potential systemic impact of misconduct risk in the EU banking sector, are:

- (a) the large costs to society and the fact that misconduct could damage confidence in financial markets and institutions, which is a vital element for the proper functioning of the financial system;
- (b) the impact of the sanctions applied to the banking sector: (i) the character of misconduct risk (typically a tail event) and the increasing size of fines create uncertainty about the business model, solvency and profitability of banks, (ii) misconduct issues often arise across markets and also in systemically important banks, and (iii) misconduct costs may rise in times of crisis and, as such, may have a procyclical impact;
- (c) the fact that, ultimately, the impact could be a withdrawal from financial markets and activities by a systemically important bank, either on a mandatory or voluntary basis, such that the functioning of a particular market is undermined.

## Section 2

### Costs to society and impact on confidence

Little is known about the actual costs to society of misconduct by banks. The ESRB has not found any comprehensive empirical evidence on the costs involved, e.g. undue rents, loss of tax income, resource misallocation, distortion of markets and loss of confidence in financial markets and institutions. However, given the large impact of the banking sector in economies, such costs are likely to be considerable.

Up until now, the focus of academia and regulatory bodies has been on the costs borne by banks, and not the costs borne by society. This is partly a result of the micro and macroprudential focus of regulators, but also because the former costs are observable in the form of fines and provisions, whereas the latter are more difficult to quantify.

The American Antitrust Institute has attempted to calculate the undue rents created by bank cartels.<sup>2</sup> As regards market manipulation, it is estimated that, on average, the overcharges of 17 cartels amount to 61% of fees, implying total overcharges of USD 347 billion. The fees involved for the foreign exchange cartel alone, which lasted 11 years, are estimated to be between USD 51 billion and USD 340 billion. According to the study mentioned in footnote 2, “antitrust injuries from banking cartels and market manipulation will rise to trillions of dollars worldwide”.

As regards mis-selling, the redress costs are more likely to approximate the direct costs to customers. The last five years have seen redress costs of more than EUR 100 billion paid to both professional and retail clients around the world (see Chart 4). In the United Kingdom alone, banks have been forced to return over GBP 18.8 billion to their customers as a result of mis-selling of payment protection insurance to date.<sup>3</sup>

Misconduct by banks also has contagion effects which may affect other sectors and society at large. It has been shown that a firm’s tendency to engage in financial misconduct increases with the misconduct rates of neighbouring firms.<sup>4</sup> Apparently, peer effects come into play here. Furthermore, there is a positive correlation between local waves of financial misconduct and local waves of non-financial corruption (e.g. political fraud). The negative impact of corruption on economic growth is evident.<sup>5</sup>

Confidence is fundamental to the stability of the banking sector and financial markets.<sup>6</sup> Issues undermining it can thus have a systemic impact. A misconduct case in one bank can quickly undermine the confidence of the public in the entire banking sector, because it is difficult for outsiders to differentiate between banks which behave well and those which behave badly.<sup>7</sup> Ultimately, loss of confidence may contribute to panic and a bank run. Moreover, since the emergence of the crisis, trust in the banking sector has been shaken at all levels, casting a shadow over the relations between banks and shareholders, between banks and debt holders and between banks and supervisors.<sup>8</sup>

---

2 Connor, John M., “Big Bad Banks: Bid Rigging and Multilateral Market Manipulation”, *American Antitrust Institute Working Paper*, No 14 (04), 5 May 2014.

3 Financial Conduct Authority, *Monthly PPI refunds and compensation*, March 2015.

4 Parsons, C.A., Sulaeman, J. and Titman, S., *The Geography of Financial Misconduct*, July 2014.

5 Mauro, P., “Corruption and Growth”, *The Quarterly Journal of Economics*, Vol. 110 (3), 1995, pp. 681-712.

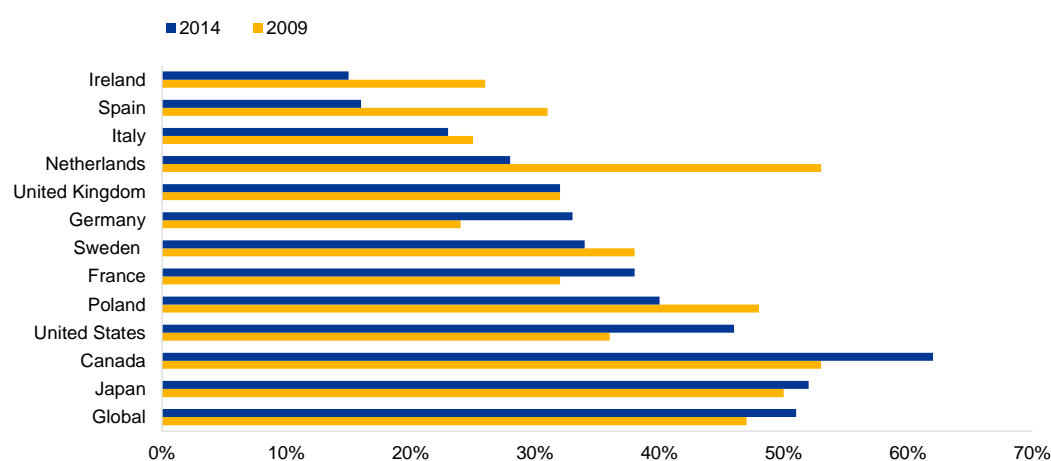
6 For an elaborate exploration of the role of confidence in economic life and its relevance to the financial crisis, see Tonkiss, F., “Trust, confidence and economic crisis”, *Intereconomics*, July/August 2009.

7 Knell, M. and Stix, H., “Trust in Banks? Evidence from normal times and from times of crises”, *Working Paper*, No 158, Oesterreichische Nationalbank, November 2009.

8 “Rebuilding trust in global banking”, remarks by Mark Carney, then Governor of the Bank of Canada and Chairman of the Financial Stability Board, to the “7th Annual Thomas d’Aquino Lecture on Leadership” held on 25 February 2013 at Western University in London, Ontario.

A survey among 33,000 customers in 27 countries reveals that the banking and financial services industry is the least trusted sector globally.<sup>9</sup> As confirmed by another global survey<sup>10</sup>, the level of trust in a number of EU Member States is lower than in other parts of the world and has not recovered since the emergence of the crisis (Chart 1).

**Chart 1**  
**Trust in banks around the globe**



Source: 2014 Edelman Trust Barometer.

Note: Respondents were asked how much they trust banks to “do what is right”.

In general, a direct link can be found between loss of public confidence in the banking sector and the financial crisis.<sup>11</sup> There is some evidence, albeit which is not strong, that confidence in banks and the financial sector is undermined by misconduct cases. The above-mentioned Edelman Trust Barometer finds that unethical business practices, failure to keep customer information secure and irresponsible behaviour in a crisis are likely to have the most negative effects on trust in any kind of business. A US survey conducted in 2009 found that respondents considered managers’ greed and poor corporate governance as the main reason behind the financial crisis.<sup>12</sup> Since then, excessive compensation and a perceived lack of integrity on the part of managers have been the two issues which have upset US citizens most. The EBA’s risk assessment questionnaire points to an increasingly negative perception of banks among the general public and an ongoing aggravation of reputational risk following the widening scope and magnitude of inappropriate practices.<sup>13</sup>

However, there is also evidence that (mis)conduct is not the main driver of confidence: a UK survey shows that the return on savings and the fees charged are more important to consumers than business ethics.<sup>14</sup> In the Netherlands, a 2013 survey found that the general public cares strongly about executive compensation, while negative media reports, falling stock prices and opaque product information also affect trust in banks.<sup>15</sup> According to this survey, experiencing a bank bailout leads to less concern than a bank failure. Negative impressions in these circumstances appear to be particularly linked to perceptions of excessive executive compensation.

There has been no clear evidence of widespread withdrawals of deposits by retail clients in the period following misconduct cases. But professional investors do appear to have reacted to mis-selling in the US residential mortgage-backed securities market, and this has impaired the functioning of that market.

9 2014 Edelman Trust Barometer.

10 Loschky, J. and Ray, J., *Europeans Give Banks Little Credit*, Gallup, 14 August 2014.

11 Osili, U.O. and Paulson, A., “Crises and confidence: Systemic banking crises and depositor behavior”, *Journal of Financial Economics*, Vol. 111, Issue 3, March 2014.

12 Sapienza, P. and Zingales, L., “The Results: Wave 1”, 27 January 2009 – related to the Financial Trust Index of The University of Chicago Booth School of Business and Kellogg School of Management.

13 European Banking Authority, *Risk Assessment of the European Banking System*, June 2014, p. 52.

14 How financial services lost its mojo – and how it can get it back, PwC, 2014.

15 Jansen, D., Mosch, R. and van der Crujisen, C., “When does the general public lose trust in banks?”, *DNB Working Paper*, No 402, November 2013.

Misconduct by banks can weaken confidence in economically important markets. The LIBOR scandal is a prime example here. A number of steps have been taken by authorities to address this. The European Securities and Markets Authority (ESMA) and the EBA have produced guidelines on benchmark setting. In the United Kingdom, the Fair and Effective Markets Review (FEMR) was initiated in June 2014 to undertake a comprehensive forward-looking assessment of the way wholesale financial markets operate, with a view to helping to restore trust in those markets in the wake of a number of high-profile cases of market abuse. The FEMR has examined potential sources of vulnerability in the structure of markets (as related to market microstructure, competition and market discipline, and benchmarks), as well as issues which may affect the conduct of market participants (standards of market practice, responsibilities, governance and incentives, and surveillance).<sup>16</sup>

---

<sup>16</sup> See <http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx>



## Section 3

### Prevention of misconduct

Given the potentially large costs to society and possible consequences for financial stability, prevention of misconduct is certainly better than dealing with it after it has occurred. The Financial Stability Board puts emphasis on prevention, supporting the strengthening of risk cultures at banks.<sup>17</sup> Prevention should address the behaviour of individuals/groups which is not aligned with the interests of customers, market participants and society at large. A robust risk culture and a strong ethical culture are crucial to preventing misconduct in institutions.

The fear of penalties alone is unlikely to prevent misconduct sufficiently. The downside risk for individuals is limited and, in large banks, inadequate systems and controls can mean that a bank's senior management is unaware of emerging misconduct issues. Misconduct is rooted in conditions commonly encountered in financial markets, such as those described below.

- (a) Misaligned incentives/moral hazard: banks may think they can get away with misconduct, believing that public authorities are unlikely to apply very significant penalties because of their systemic nature. Individuals may have a short-term horizon and care less about the long-term repercussions for a bank. Also, both individuals and banks may misjudge the likelihood that misconduct will be noticed, and, if it is noticed, that it will be sanctioned.
- (b) Information asymmetry and conflicts of interest: information asymmetries and conflicts of interest between banks and customers can lead to mis-selling, for instance of complex products to retail clients. Information asymmetries may also occur within an institution, e.g. if a risk or compliance department is unable to handle all the information coming from the front office properly. Likewise, conflicts of interest may arise between banks and other financial participants, for instance when a rating agency, auditor or consulting firm is paid by a bank. It can also occur within a bank, in cases, for example, where remuneration policies are not aligned or Chinese walls between advisory services and trading are not secure.
- (c) Herding behaviour: herding behaviour can mean that misconduct at one bank spreads across the sector, as the behaviour comes to be seen as the "market norm" and no bank wants to forgo the extra earnings it may generate. This has been witnessed in the case of benchmark manipulation, which was widespread among a large share of the relevant panels. Hence, misconduct risks are likely to be correlated across institutions, creating a risk for the system as a whole.
- (d) Lack of competition: a lack of competition may lead banks to mis-sell products, as customers have a limited choice of banks. In addition, it may result in tacit collusion, especially in highly concentrated markets. An example is price fixing by a group of banks with the objective of reducing quantities and increasing margins at the expense of customers.

Governance and internal controls at banks are of key importance in preventing misconduct. Under an annual study of risk management practices, 40 of the 52 banks surveyed stated that weak oversight and controls had led to the operational losses incurred over the past five years.<sup>18</sup> Also, most banks were of the opinion that striking a balance between a sales-driven front-office culture and a firm-wide risk culture was the key challenge in terms of strengthening their risk culture.

There are a number of functional areas where banks should be taking steps to prevent misconduct, including not just the compliance function but also senior management and the Executive Board. Board members and senior management should identify conduct risk based on the context of the bank's business. The board should set the "tone at the top" and oversee management's role in fostering and maintaining a sound corporate and risk culture. Given that financial markets and products have

<sup>17</sup> See, for example, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture – A Framework for Assessing Risk Culture*, Financial Stability Board, 7 April 2014.

<sup>18</sup> Ernst & Young, *Shifting focus: Risk culture at the forefront of banking*, 2014.

become more complex, simply ticking the box of easy rules no longer suffices when it comes to the compliance function. It should apply a broader approach, going beyond the rules, whereby it proactively searches for all kinds of misconduct risks.

Besides a robust risk culture, a strong ethical culture should make banks less vulnerable to misconduct. A survey of 500,000 employees working for different types of companies (i.e. not just banks) in more than 85 countries has found that firms with strong ethical cultures experience less misconduct. Indeed, employees of companies with a veritable culture of integrity appear to have a 67% lower chance of observing business misconduct (e.g. accounting irregularities, insider trading) than those where such a culture is less developed. In the former type of firm, effective preventive measures help to ensure open communication between employees and managers, building trust in leadership.<sup>19</sup>

Regulation should strengthen internal governance and risk management practices. Indeed, there are a number of regulations which include a broad range of preventive supervisory rules: the Capital Requirements Directive (CRD IV; specifies governance requirements for banks), Anti-Money Laundering Directive, Market Abuse Directive (addresses market manipulation), Alternative Investment Fund Managers Directive (AIFMD), Directive 2014/91/EU (UCITS V on undertakings for collective investment in transferable securities), the PRIIPS Regulation (on packaged retail and insurance-based investment products), the Mortgage Credit Directive (MCD), the Consumer Credit Directive (CCD), and the Markets in Financial Instruments Directive (MIFID II; addresses conduct in financial markets, in particular that towards customers). In the context of these Directives the European Supervisory Authorities have contributed with the following:

- (a) guidelines on internal governance<sup>20</sup> containing specific principles that banks should apply to address misconduct risk;
- (b) guidelines for the assessment of the suitability of management body members, highlighting the crucial role of the internal control function<sup>21</sup>, which should prevent misconduct by senior management;
- (c) principles for benchmark setting<sup>22</sup> in the European Union, which should prevent benchmark manipulation;
- (d) a “reminder” on self-placement<sup>23</sup> (the sale of own liabilities to clients) and the drivers behind mis-selling (i.e. the design and marketing of financial products, and remuneration arrangements for sales staff), which should prevent mis-selling practices;
- (e) prospective guidelines on cross-selling addressing the risks to consumers arising from this practice;
- (f) guidelines on remuneration policies and practices<sup>24</sup>, which should prevent all categories of misconduct by individuals;
- (g) guidelines on product oversight and governance requirements for manufacturers and distributors, aimed at significantly reducing mis-selling;<sup>25</sup>
- (h) guidelines on complaints-handling for the securities (ESMA) and banking (EBA) sectors.<sup>26</sup>

---

19 Corporate Executive Board, *Research Reveals That Integrity Drives Corporate Performance: Companies With Weak Ethical Cultures Experience 10x More Misconduct Than Those With Strong Ones*, 15 September 2010. (<http://news.executiveboard.com/index.php?s=23330&item=50990>).

20 EBA Guidelines on Internal Governance (GL 44), 2011.

21 EBA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2012/06), 22 November 2012.

22 ESMA-EBA Principles for Benchmark-Setting Processes in the EU, 6 June 2013.

23 Placement of financial instruments with depositors, retail investors and policy holders ('Self placement'), JC 2014(62), 31 July 2014.

24 ESMA, *Final report – Guidelines on remuneration policies and practices*, 11 June 2013.

25 ESMA, *Joint Position of the European Supervisory Authorities on Manufacturers' Product Oversight & Governance Processes*, JC-2013-77.

26 ESMA, *Joint Committee Final Report on guidelines for complaints-handling for the securities (ESMA) and banking (EBA) sectors*, JC-2014-43.

In the SREP, supervisors must assess a bank's internal governance, risk culture and internal control arrangements, and evaluate all risks, including the risks which a bank poses to the financial system.<sup>27</sup> The EBA guidelines for common procedures and methodologies for SREP provide guidance for the supervisory assessment of conduct risk.<sup>28</sup> Pillar 2 measures can address identified deficiencies in governance, the risk culture and internal control arrangements, as well as ensure that banks hold additional capital to cover potential misconduct risk (a capital add-on).

As imposing penalties and sanctions on banks is more likely to penalise a bank and its shareholders rather than the individuals responsible, further consideration on the benefits of holding senior individuals to account for regulatory breaches and misconduct in firms may be merited. For example, in the United Kingdom, the Bank of England and the Financial Conduct Authority are now implementing the Senior Managers Regime (SMR), which will come into force by 7 March 2016. Under the SMR, the most senior managers of a firm will be allocated responsibility for ensuring compliance with a number of regulatory requirements, including "embedding" the firm's culture and standards. In the event that there is a regulatory breach in an area assigned to an individual senior manager, there will be a "presumption of responsibility", whereby the senior manager concerned is held responsible for that breach: he/she will face a regulatory/civil sanction, unless it can be proven that he/she took "reasonable steps" to prevent the breach from occurring. If a senior manager's recklessness causes a firm to fail, he/she may face criminal sanctions, including a custodial sentence. Making higher-level staff accountable for wrongdoing could arguably better incentivise senior management to ensure that misconduct does not take place in their bank than a punishment applied to the bank as a whole.

In addition, the incentives for bank staff, in particular those in management, should be aligned with risks to the bank and society at large. As indicated above, where the bank (rather than its management) is held liable for misconduct and management receives undue rents from such behaviour, misconduct by management may be incentivised. Making management staff liable for their misconduct and ensuring sufficient variable remuneration which can be clawed back in some way would help to align incentives with the interests of the bank and society, and to encourage a sound risk culture within the banking sector. The relative increase in fixed pay at the expense of variable pay may thus be a negative factor, limiting the extent to which incentives can be aligned through the use of measures such as malus and clawback provisions. In this respect, the completion of the implementation of the FSB's Principles for Sound Compensation Practices is welcomed, as is its more recent attention to the use of malus and clawback clauses to address misconduct.<sup>29</sup>

---

27 See Article 97 of the CRD IV (Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC, OJ L 176/338).

28 EBA Guidelines for common procedures and methodologies for the supervisory review and evaluation process (SREP), 19 December 2014

29 Financial Stability Board, *Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards – Third progress report*, 4 November 2014.

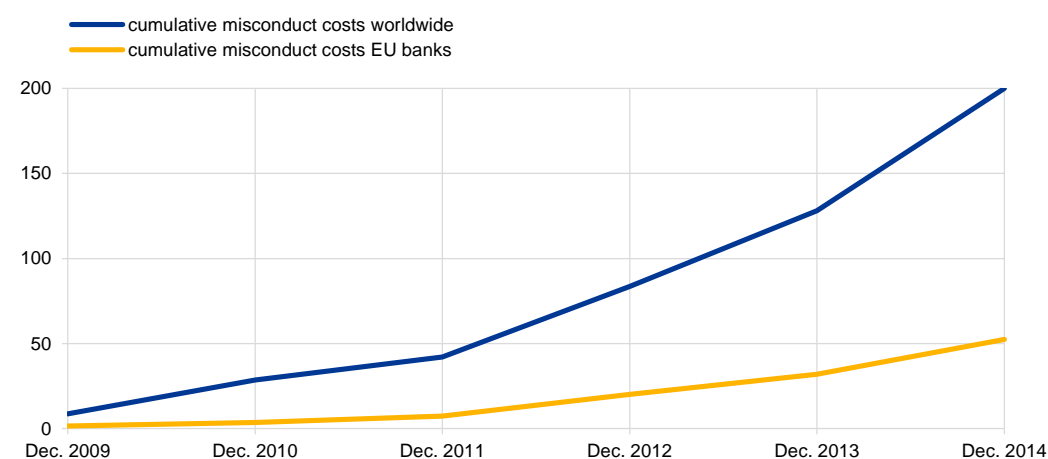
## Section 4

# Penalties imposed in misconduct cases and consequences for financial stability<sup>30</sup>

Penalties can be in the form of monetary sanctions or business restrictions. The latter are discussed in Section 6, the former in this section. Fines, settlements and redress costs rightly aim to punish firms for the costs to society caused by misconduct and to discourage misconduct in the future. Over the past five years the related amounts have been increasing, reaching a cumulative total of around EUR 200 billion for all banks and EUR 50 billion for EU banks (Chart 2). Similar principles apply to the penalties for misconduct in the European Union and the United States. In particular, the authorities in both jurisdictions apply the principle of proportionality. However, in practice, fines, settlements and redress costs have been considerably higher in the United States (Chart 3).

**Chart 2**  
**Cumulative misconduct costs for banks since 2009**

(EUR billions)



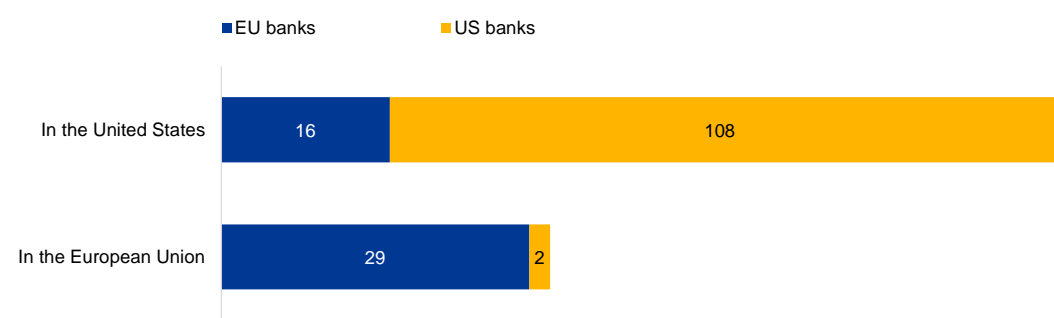
Sources: CCP Research Foundation (<http://conductcosts.ccpresearchfoundation.com/index>), Financial Times, Financial Conduct Authority and ESRB calculations.

Notes: Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, Wells Fargo, Ally financial, SunTrust and JP Morgan Chase & Co. represent US banks, while EU banks are represented by Barclays, BNP Paribas, HSBC, Lloyds Banking Group, Royal Bank of Scotland, Société Générale, Deutsche Bank, ING, Rabobank, Standard Chartered and Santander. Misconduct costs of EU and US banks arising from legal action outside the European Union/United States and the penalties of banks from other countries account for EUR 44 billion.

<sup>30</sup> Several sources have been used to quantify the penalties imposed on banks in misconduct cases. As different sources give different numbers, the averages or the most common estimates have been used. Consequently, the numbers in this report should not be considered as exact amounts but as the ESRB's estimates. The cut-off date of the data is 1 May 2015. Note that data on misconduct for the period before 2008 are excluded, owing to their scarcity. Less attention was paid to this issue in the past and the amounts involved were also much smaller.

**Chart 3**  
**Fines, settlements and redress costs as a result of US and EU authorities**

(EUR billions; 2009-14)



Sources: CCP Research Foundation (<http://conductcosts.ccpresearchfoundation.com/index>), Financial Times, Financial Conduct Authority and ESRB calculations.

Notes: Bank of America, Citigroup, Goldman Sachs, Morgan Stanley, Wells Fargo, Ally financial, SunTrust and JP Morgan Chase & Co. represent US banks, while EU banks are represented by Barclays, BNP Paribas, HSBC, Lloyds Banking Group, Royal Bank of Scotland, Société Générale, Deutsche Bank, ING, Rabobank, Standard Chartered and Santander. Misconduct costs of EU and US banks arising from legal action outside the European Union/United States and the penalties of banks from other countries account for EUR 44 billion.

Misconduct takes place across different markets. In the United States, the majority of fines are related to developments that have taken place in the mortgage market following the subprime crisis. Meanwhile, EU fines are predominantly a result of mis-selling of guaranteed investment products and market manipulation. Such fines are not restricted to single banks but have an industry-wide dimension. Indeed, for the period concerned, less than 5% of fines and settlements were of a firm-specific nature; the rest involved several large banks in a number of jurisdictions (Chart 4).

Fines are concentrated among the major players – the so-called global systemically important banks (G-SIBs). By 2013, some 85% of these fines had been made against ten banks in the top three “buckets” of the G-SIB classification.<sup>31</sup> Both this concentration and the industry-wide phenomenon emphasise the systemic relevance of the issue.

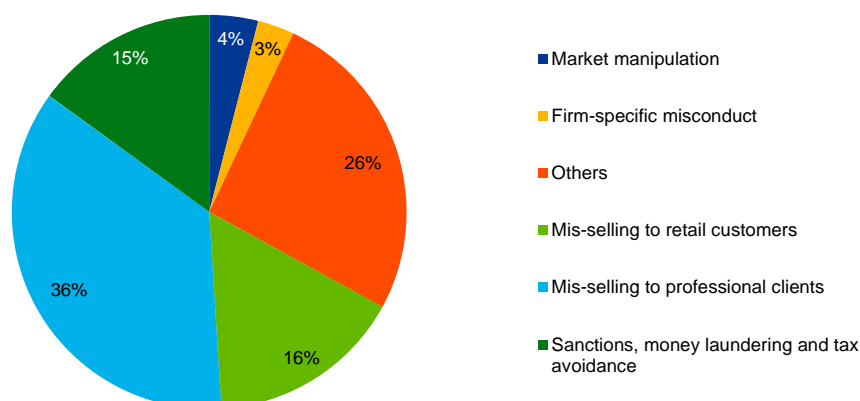
Misconduct penalties may rise during crises. Operational risk losses (these are much broader than misconduct-related penalties but may serve as an approximation) for the 200 largest banks show that the severity of losses increased dramatically with the onset of the recent financial crisis and the corresponding recession, giving the distribution a fatter tail.<sup>32</sup> The same does not apply to loss frequency (Table 1). These developments can be explained by a number of factors. First, operational losses are the result of increased economic activity prior to the recession; operational risk losses are therefore a reflection of prior exuberance, with the operating environment and control structure of a financial institution becoming weaker, and the implementation of controls possibly being viewed as running counter to growth and entrepreneurship.<sup>33</sup> Second, as regards mis-selling, when market conditions become more volatile, losses continue to increase and become more visible. And once these losses are discovered, they can be huge. Third, when banks are under severe stress, they often experience changes in their operating model and the attention of senior management is elsewhere, perhaps to the detriment of operational control.

<sup>31</sup> This result may be biased, as databases on fines and settlements focus on large banks.

<sup>32</sup> Esterhuysen, J. et.al., “The effect of stressed economic conditions on operational risk loss distributions”, *South African Journal of Economic and Management Sciences*, Vol. 13, No 4, 2010.

<sup>33</sup> Lantsman, Y. and Cagan, P., “The cyclicity of operational risk: The tracking phenomenon”, *IBM Algo Operational Risk Capital Modeling White Paper*, November 2007.

Chart 4  
**Misconduct categories**  
 (2009-13)



Sources: CCP Research Foundation, Financial Times, Financial Conduct Authority, Risk.net and ESRB calculations.  
 Note: "Others" is mostly related to mortgage foreclosure abuse in the United States.

Table 1  
**Operational losses before and during the financial crisis**

	Before crisis	During crisis
Period	2003 to mid-2007	mid-2007 to 2009
Average frequency / 100 days)	42	30
Number of cases	697	205
Average size of loss	USD 0.17 billion	USD 1.80 billion
Standard deviation	USD 0.84 billion	USD 8.56 billion
Median loss	USD 3 million	US\$ 60 million
Maximum loss	USD 9.3 billion	USD 85 billion

Sources: Esterhuysen et al. (2010) and Algo FIRST (a database with information on over 7,500 external loss events experienced by the world's biggest 200 banks).

Legacy costs related to misconduct represent a substantial drag on banks' profitability and capital ratios. Bank analysts<sup>34</sup> estimate that the fines and settlements registered by EU banks in the period up to the first quarter of 2014, totalling around EUR 40 billion, are likely to increase by a further EUR 50 billion from then onwards.<sup>35</sup> Banks' annual reports show that penalties are often imposed for manipulation of foreign exchange and metal markets, tax evasion, money laundering, embargo breaches, and mis-selling of payment protection insurance and car loans.<sup>36</sup> Banks have not yet raised their provisions accordingly (Chart 5). Predicted future costs already exceed the costs which have been incurred in many cases (Chart 6).

Without past litigation costs and provisioning for future litigation costs, the total accumulated profits of EU G-SIBs for the past five years would have been a third higher. Past fines and ones in the near

34 See the 4 June 2014 note on "Multinational Banks" by the Equity Research Europe arm of Credit Suisse and Morgan Stanley's "Wholesale & Investment Bank Blue Paper Revisit", No 13 (4).

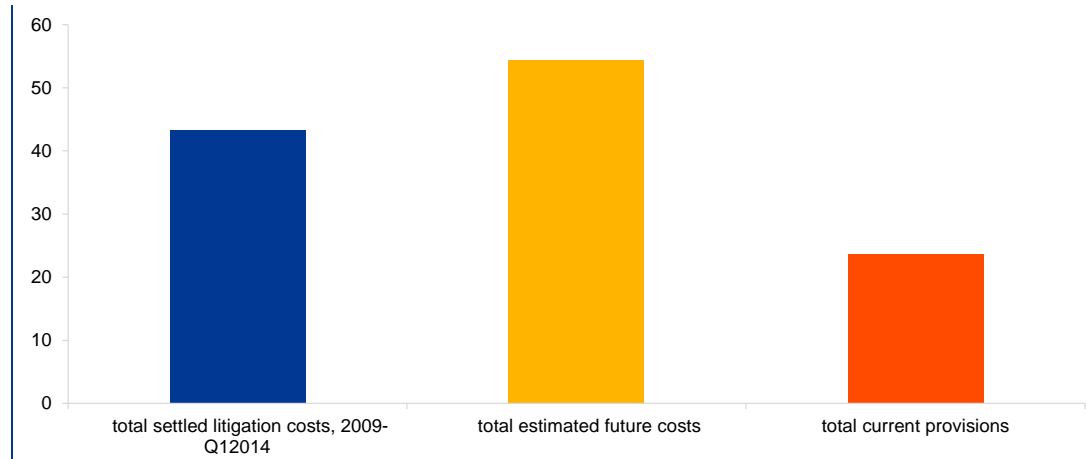
35 There are no reliable public data on expected future misconduct costs. In principle, data on provisioning should give some insight. However, banks with pending legal disputes are not eager to report expected future losses and some banks only report their provisioning for operational losses, which is broader than misconduct costs, to avoid legal risks. Reflecting the uncertainty in this area, market analysts' estimates of future costs are divergent and thus should not be heavily relied upon.

36 2014 annual reports of EU G-SIBs and Commerzbank.

future erases all the capital issued by EU G-SIBs during the last five years. The Common Equity Tier 1 ratios of these banks would be, on average, around 2 percentage points higher without such fines.

**Chart 5**  
**Misconduct costs and provisions of EU G-SIBs**

(EUR billions)

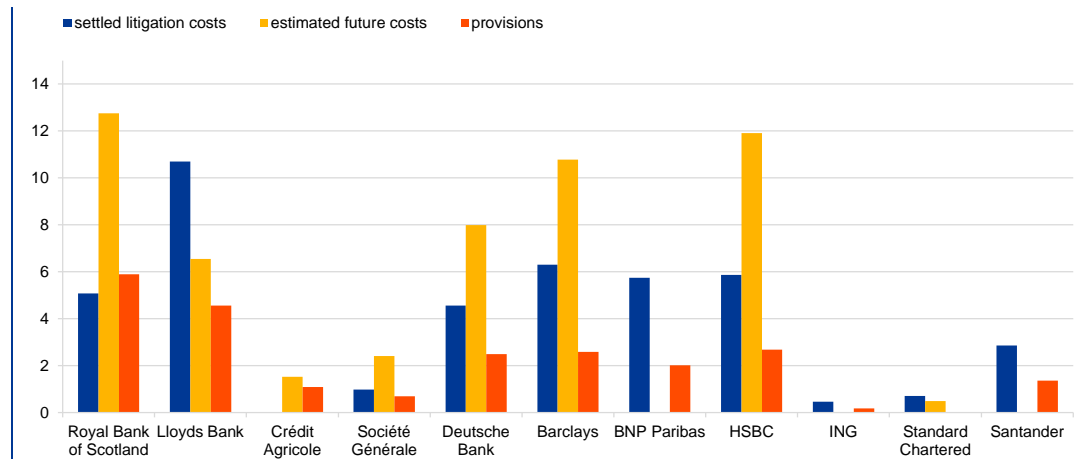


Sources: Credit Suisse, Morgan Stanley, Dealogic, Financial Times and ESRB calculations.

Notes: Provisions for Barclays, BNP Paribas, Crédit Agricole and Deutsche Bank are as at mid-2014. Provisions for Société Générale, Royal Bank of Scotland, BNP Paribas, HSBC, ING and Standard Chartered are as at end-2013. The EU G-SIBs UniCredit and Banco Bilbao Vizcaya Argentaria are not included owing to lack of information.

**Chart 6**  
**Misconduct costs and provisions of individual EU G-SIBs**

(EUR billions)



Sources: Credit Suisse, Morgan Stanley, Dealogic, Financial Times and ESRB calculations.

Notes: Provisions for Barclays, BNP Paribas, Crédit Agricole and Deutsche Bank are as at mid-2014. Provisions for Société Générale, Royal Bank of Scotland, BNP Paribas, HSBC, ING and Standard Chartered are as at end-2013. The EU G-SIBs UniCredit and Banco Bilbao Vizcaya Argentaria are not included owing to lack of information.

Misconduct costs are not restricted to direct fines (imposed by courts and regulators) and settlements (arranged with prosecutors). They can also reflect redress costs, which may be spread over many years, as has been observed in the case of payment protection insurance in the United Kingdom. In addition, banks bear the costs of expanded legal departments and fees for external consultants and

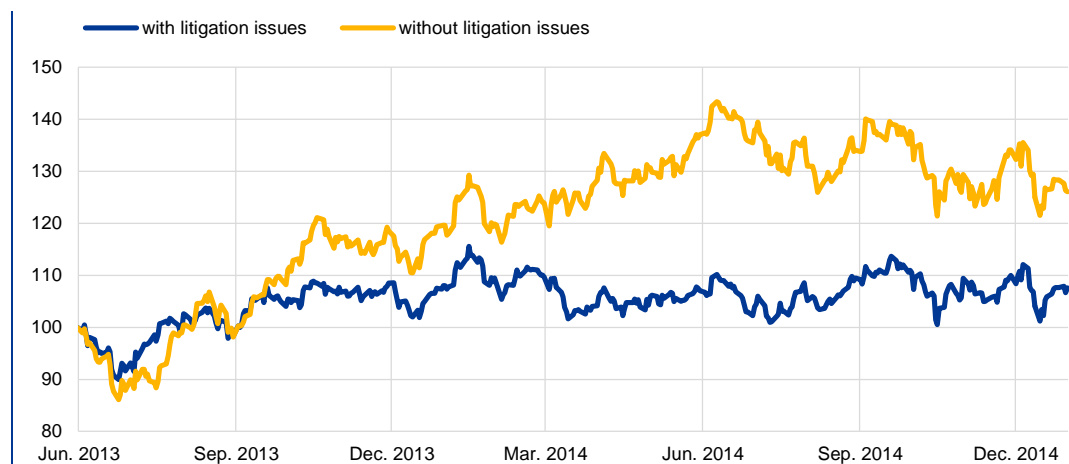
legal advisers. In one survey, 84% of banks reported an increase in litigation spending since 2008.<sup>37</sup> In 2012 Lloyds Banking Group estimated that administrative costs equalled over 15% of the total cost of claims related to payment protection insurance made that year.<sup>38</sup>

Moreover, banks incur reputational damage, which harms future sales and funding conditions. For instance, the “reputational penalty” is estimated to be 7.5 times the total amount of penalties imposed by the U.S. Securities and Exchange Commission on the 585 firms subject to enforcement actions for financial misrepresentation between 1978 and 2002.<sup>39</sup>

In the long run imposing stiff penalties on firms may increase public confidence in the banking sector (i.e. if they are seen as driving positive change), but in the short run has the potential to undermine it. On the one hand, penalties aim to prevent future misconduct and, as such, increase the confidence of stakeholders in the financial system. But on the other hand, when misconduct is revealed by authorities – often against a backdrop of heightened media attention – confidence can be shaken. This would be particularly relevant if public perceptions of a firm’s financial strength and its ability to maintain adequate capital buffers are also affected.

Finally, uncertainty about often long-lasting litigation may have a negative impact on the value of banks. Chart 7 shows that, since September 2013, the equity prices of banks with substantial legacy problems have underperformed those of other banks.<sup>40</sup> The market capitalisation of the banks with litigation issues would have been EUR 54 billion more in December 2014 if their share prices had followed the same trend as those of the banks without any litigation issues. While other factors may account for this, it seems highly likely that the market is, to some extent, punishing those banks with misconduct issues which have not been settled.

**Chart 7**  
**Banks’ share performance with and without litigation issues**



Sources: Credit Suisse and Bloomberg.

Notes: EU G-SIBs in the “litigation issues” group are: BNP Paribas, Crédit Agricole, Natixis, Société Générale, Deutsche Bank, HSBC, Barclays, Lloyds Banking Group, Royal Bank of Scotland and Standard Chartered. EU G-SIBs with no pending litigation are: Unicredit, Santander, Banco Bilbao Vizcaya Argentaria and Nordea.

37 See Stephenson Harwood and Legal Business, “Hunting titans. An insight special on banking litigation”, Legal Business, December 2013/January 2014.

38 See [http://www.lloydsbankinggroup.com/globalassets/documents/investors/2012/2012\\_lbg\\_rando\\_interactive.pdf](http://www.lloydsbankinggroup.com/globalassets/documents/investors/2012/2012_lbg_rando_interactive.pdf), page 17.

39 Karpoff, Jonathan M., Scott Lee, D. and Martin, Gerald S. “The Cost to Firms of Cooking the Books”, *Journal of Financial and Quantitative Analysis*, Vol. 43 (3), September 2008, pp. 581-612.

40 This does not necessarily imply a causal relationship, as it could be that certain characteristics are responsible for the poor performance of banks with pending litigation.



## Section 5

### Capital covering misconduct risk

As with other risks, in principle, expected losses from known misconduct issues should be provisioned for and included in the profit and loss account, whereas unexpected losses should be quantified and covered by capital. Recent manifestations of misconduct risk have highlighted deficiencies in both provisioning and capital requirement calculations. Banks are making provisions for future misconduct costs (charts 5 and 6). But their provisioning has often been too little and too late, given the magnitude of the penalties applied and the limitations of provisioning.

Microprudential operational risk (of which misconduct risk is a subset) charges are calculated using three methods – the Basic Indicator Approach (BIA), the Standardised Approach (TSA) and Advanced Measurement Approaches (AMA). The last of these is most relevant for many G-SIBs. AMA use loss data for at least the past five years, additional scenarios and risk indicators, whereas BIA and TSA are based on a calibration from the early 2000s, when little was known about operational risk, an adequate loss data base was not available, and misconduct costs were not as large as now. Banks are likely to use the same approaches for their Internal Capital Adequacy Assessment Process (ICAAP), possibly with a small add-on. The EBA has recently clarified how misconduct risk can be taken into account in the calculation of capital requirements in AMA.<sup>41</sup>

As part of the Pillar 2 process, banks and supervisors should assess whether sufficient capital is set aside for operational risk, including misconduct risk. This could be done by including misconduct risk in regular stress tests. Under AMA, it is already required that banks test the assumptions of the models regularly applied. Stress tests are run by both banks and supervisors. The former use them in their ICAAP, while the latter conduct macro stress tests. It is important that misconduct costs are captured by stress tests in a credible fashion. It is equally important that confidential information is not leaked, in order to avoid sudden and large market reactions.

There is, however, no uniform approach or benchmark when it comes to testing misconduct risk. The Federal Reserve System, EBA and Bank of England included misconduct risk in their 2014 stress tests via different approaches, each with its own advantages and disadvantages:

- (a) A model-based approach was applied by the Federal Reserve in its March 2014 Comprehensive Capital Analysis and Review (CCAR). Operational losses of approximately USD 130 billion to USD 150 billion over nine quarters were included in its scenarios, which also covered litigation costs. This estimate was based on increasing provisions for known cases and projected losses for unknown cases. For these projected losses, a panel regression model, the Loss Distribution Approach and a historical simulation approach were used, based on historical data submitted by the banks. The Federal Reserve assumes there is a dependency between macroeconomic variables and underlying operational risk events.<sup>42</sup> A strength of this approach is its consistency across banks. A shortcoming, however, is its reliance on historical data: the strong increase in the magnitude of fines means that such an approach may not be fully reliable. Also, there is significant model risk associated with this method.
- (b) In the Bank of England's 2014 stress test, banks were requested to assess future misconduct-related costs and to include them in their projections. The Bank of England then estimated the future misconduct costs on a case-by-case basis and compared the results with the aggregate conduct-related cost included in each bank's projections. Supervisors exercised their judgement to ensure that there was an additional buffer against any costs that could not then be quantified. If provisions were judged to be insufficient, the baseline capital was adjusted before the test

41 In particular, as per Article 312(4) of the CRR, the EBA has released on 5 June 2015 the Final draft regulatory technical standards specifying the assessment methodology under which competent authorities permit the use of AMA: <http://www.eba.europa.eu/documents/10180/1100516/EBA-RTS-2015-02+RTS+on+AMA+assessment.pdf>.

42 This is a key difference compared with traditional Basel II approaches. Under the CCAR framework, the scenario (which varies over time) determines dynamically the frequency and severity distributions. These distributions are then aggregated to determine the operational risk in each forecasted period.

was applied. Strengths of this approach include its individual application (misconduct risk varies across the banking sector) and the supervisory scrutiny possible – supervisors are able to challenge banks' estimates (which are often too low). However, this supervision-driven approach also has its drawbacks as the methodology is not transparent. In addition, a negative market reaction may occur if bank-specific data, in particular estimates made by supervisors, are inadvertently disclosed.

- (c) A bank-driven case-by-case approach was applied by the EBA and the Single Supervisory Mechanism: In the 2014 EBA stress test, banks were requested to assess future conduct-related costs and to include them in their projections, either in the profit and loss account or as additional reserves. No methodology was specified. A strength of this approach is its individual application. But its shortcomings include a lack of transparency and lack of supervisory challenge.

A hybrid approach, capturing different elements of the above listed approaches could be conceivable too. For instance, a stress test, run by the bank, based on a pre-described scenario and possibly including bank-specific characteristics, subject to supervisory challenges. As regards the bank-specific characteristics, information on these should remain confidential because markets and customers may act upon it if it is made public, thereby reinforcing potential risks for the bank. As regards the scenario, this would ideally:

- (a) be forward looking and not solely based on historical misconduct events, given the structural break in the size of penalties;
- (b) be based on the economic and financial conjuncture, given the potential correlation between the cycle and the size of operational risk events (see Section 4);
- (c) include severe idiosyncratic events, given that the degree of misconduct risk varies significantly between different types of banks.

For this approach to be successful, it should start with a clear and transparent methodology; one which is sustainable year-after-year and consistent across (similar types of) banks so that it contains limited judgement about potential losses related to individual banks. Also, in order to have sufficient quality assurance, it should be coupled with top-down quantitative benchmarks, as a necessary step to ensure consistency in the treatment of misconduct risk across institutions.

It is worth observing that the BCBS has recently developed a methodology for the estimation of a bank's operational capital-at-risk (OpCaR), which has been applied in the review of simpler approaches for operational risk and is also used for AMA benchmarking purposes.<sup>43</sup> Therefore, it would be useful that future EU stress tests take into consideration this methodology and, if possible, make use of it either in the stress tests or in the supervisory challenge.

Pillar 2 measures can correct for identified undercapitalisation of risks not covered by Pillar 1. In cases where the supervisor determines that the bank does not hold sufficient capital against misconduct risk, as assessed in the ICAAP, stress test or SREP, it can require the bank to hold more capital.<sup>44</sup> The ESRB Handbook on Operationalising Macro-prudential Policy in the Banking Sector indicates that Pillar 2 measures are useful for dealing with systemic risks arising from individual banks. This also applies to misconduct risk with potential systemic implications. Consequently, the SREP assessment should not only consider the risks which the bank is exposed to, but also their systemic impact, i.e. the likely threat to the financial system arising from any misconduct issues.

---

43 The OpCaR methodology is described in Annex 2 of the BCBS document available at <http://www.bis.org/publ/bcbs291.pdf>

44 See Article 104 of Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2014 (CRD IV).

## Section 6

### Business restrictions

Apart from direct financial consequences and indirect reputational consequences, banks' business models may also be affected by misconduct issues. This is relevant from a macroprudential perspective. Some restrictions on banking activities have the potential to threaten the viability of systemically important banks and the functioning of financial markets. Restrictions on their activities can be imposed by authorities as a result of misconduct issues. Banks may also voluntarily withdraw from certain markets or operations, with a view to preventing future misconduct cases. Meanwhile, legal uncertainty arising from long litigation processes or different legal judgements in equal or very similar misconduct cases could introduce a lack of confidence in banks and thus create incentives for self-restrictions in their business models.

Financial fines, particularly significant ones, will erode the capitalisation and profitability of banks. However, it is unlikely that these alone would lead to a bank failure. The impact of business model restrictions (that is, a prohibition on undertaking certain activities, such as making payments via payment systems for own benefit or on behalf of clients) may be less well understood, and, if misjudged, have the potential to quickly prompt negative consequences. Hence, there is perhaps a greater risk that the imposition of business restrictions may itself create systemic risks.

There is one clear example of this: banks that are direct members of payment systems rely on their access to such systems to make payments at both the domestic and international levels. Payments are often made on behalf of financial and non-financial clients (this practice is known as correspondent banking when carried out on behalf of other banks). Recently, the US authorities have punished some banks by selectively restricting access to US payment systems for certain activities, and for a limited period of time. Although the impact of these sanctions has been relatively small to date (owing to their targeted nature), a more general prohibition on access to payment systems would have a significant impact on the viability of a firm and on the provision of financial services. This is a particularly relevant point regarding US payment systems because of the central role of the US dollar in international trade and financial transactions.

In the recent cases where access to US payment systems has been restricted by US authorities, this has been in response to deficiencies in anti-money laundering systems or because of banks making payments on behalf of clients subject to US sanctions. One step which could potentially help prevent these types of risk would be greater use of legal entity identifiers (LEIs). These are part of a global initiative sponsored by the G20, which plans to identify the counterparties in financial transactions by assigning each one a unique reference number. Around 300,000 firms around the world have obtained an LEI as a result of the European Market Infrastructure Regulation (EMIR), the Dodd-Frank Act or the CRD IV.

The LEI scheme improves the ability of both firms and authorities to manage information on other entities. If a wider range of entities (currently, the global allocation of LEIs is largely driven by derivatives trading requirements in the EMIR and the Dodd-Frank Act) had an LEI or payments had more detail on the counterparty involved, it could help authorities to clarify unambiguously which entities banks should avoid in order to comply with financial sanctions. It could also help banks compile and manage lists of higher-risk entities. However, for this initiative to have a significant impact, it would need to be pursued at a global level, rather than within the EU.

In addition, it should be noted that expanding the LEI scheme will not provide a fail-safe solution to the problem of preventing banks from dealing with prohibited counterparties. There may also be some implementation challenges in terms of ensuring that adequate checks are undertaken to confirm that an institution is legitimate prior to the allocation of an LEI.

As noted above, misconduct issues may also influence banks' own business decisions. The phenomenon of banks withdrawing from geographical areas and business lines deemed to be "high risk" is known as de-risking. De-risking, however, should only be seen as a negative issue when banks

pull back from legitimate business activity because of concerns that sanctions may be imposed. Genuine action aimed at reducing potential misconduct risk should be seen in a positive light.

Banks should be free to choose their own risk appetite (within the parameters set out by regulation) and it is unlikely that national authorities could or should seek to alter this. However, one could argue that national or EU authorities could provide greater certainty on the scope of sanctions.

Sanctions may be ambiguous, either by accident or design. In the latter case, their vagueness is intended to encourage firms to take a more conservative approach to business decisions. This may increase operational risk, including legal risk, and could lead to an overly conservative approach by banks. There may be some merit in authorities considering giving greater guidance to banks on the scope of sanctions to avoid this risk. For example, the Office of Foreign Assets Control of the U.S. Department of the Treasury regularly publishes questions and answers on US sanctions on its website.<sup>45</sup>

---

<sup>45</sup> [http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/ques\\_index.aspx](http://www.treasury.gov/resource-center/faqs/Sanctions/Pages/ques_index.aspx)

## Section 7

### Coordination of measures to address misconduct

Penalties applied to banks by one national authority in response to misconduct may have implications for financial stability in other jurisdictions. While it would be inappropriate for domestic legal procedures to be interfered with, it is important that authorities across jurisdictions are as coordinated as possible – for example, through effective information exchange – to ensure that any spillover effects are effectively mitigated or managed and to avoid an uneven playing field. In misconduct cases, the evenness of the playing field may be affected in three ways:

- (a) since courts are independent from one another, the same misconduct behaviour could lead to unequal penalties being applied to various institutions within a single jurisdiction;
- (b) if an offence exists in different jurisdictions, it could be sanctioned differently, depending on where the offence is prosecuted;
- (c) if an offence is country-specific, it could lead to sanctions being imposed on an institution originating from a country where a certain behaviour is not considered to be illegal, implying that other institutions would not be prosecuted for behaving in the same way.

A number of steps have been taken at the EU and international levels to improve coordination among supervisors, for example, through the establishment of supervisory colleges. Such arrangements need to be built upon: it is clear that there is some scope to improve coordination and cooperation when penalties are being applied, particularly between home and host supervisory authorities.

Although it has not been identified as a systemic risk, more consistent approaches to the enforcement and prosecution aspects of sanctions established in the European Union may help mitigate any risk of uncoordinated approaches in future. In this context, the ongoing discussions at the EU level on the need for more consistent enforcement and prosecution regarding sanctions has been noted.<sup>46</sup>

Furthermore, misconduct issues often involve a number of different authorities (supervisors, central banks, prudential and conduct regulators, as well as the judiciary, courts and finance ministries). Each of these has differing objectives and perspectives on misconduct issues and it is often the case that not all of these interested parties are represented at international meetings and discussions, such as crisis management groups. As such, greater cooperation among this diverse range of bodies, and perhaps another forum which brings together the relevant interested parties to discuss misconduct issues internationally, may be advantageous (of course, this should not impinge on the judicial process).

There may also be merit in devising a set of best practice principles for national authorities to follow when applying penalties to cross-border banks to ensure adequate coordination and communication. These principles should be seen as complementary to the BCBS's Principles for effective supervisory colleges and, at the EU level, the technical standards and guidelines which govern the operations of the EBA's supervisory colleges. For these principles to be truly effective, they would need to be agreed and implemented at the international level.

The list below is a non-exhaustive set of principles which supervisory and regulatory authorities ideally ought to follow when dealing with other national authorities, namely when they are applying sanctions which could have systemic implications for those national authorities' jurisdictions. It should be noted that these are just initial thoughts and that the principles would need to be developed further.

- (a) Where the impact of a penalty imposed on a bank may have negative consequences for financial stability in another jurisdiction, the authority applying the penalty should ensure that it establishes an open dialogue with the relevant authorities in a timely fashion. This should occur

---

<sup>46</sup> European Commission, *Reinforcing sanctioning regimes in the financial services sector*, Commission Communication COM(2010) 716 of 8 December 2010.

where the authority imposing the penalty is the home authority of a bank with significant operations abroad, and where it is a host of a foreign bank.

- (b) The authority imposing the penalty should inform the relevant authorities of the issue as soon as it is practical to do so.
- (c) The authority applying the penalty should provide adequate information to the relevant authorities, including but not limited to (i) what it believes has happened, (ii) where the event concerned is believed to have taken place, (iii) what possible action could be taken, and (iv) what remediation is likely to be required.
- (d) An open dialogue should be continued throughout the process and the authority applying the penalty should update other relevant authorities on significant developments in the process.
- (e) Communication between authorities should always be done directly and not through firms.

More generally, the issue of international coordination on misconduct issues may be worthy of further discussion at the international level, for example, by the Financial Stability Board or the BCBS.<sup>47</sup>

---

<sup>47</sup> Also OICV-IOSCO or FINCONET, which has a mandate regarding conduct of business issues, can serve as useful coordination fora. Cooperation between these different fora could ensure a proper coordination between prudential and conduct regulators.

## Section 8

### Possible next steps

Based on the above analysis, the ESRB highlights the following steps to support prevention of misconduct, to ensure sufficient provisioning by banks, and to improve coordination between the relevant authorities.

- (a) Given the costs to society and risks to financial stability, preventing misconduct is absolutely essential. Therefore, as a first step, prudential and conduct regulators should continue efforts aimed at requiring banks to adopt behaviours, practices and internal control/compliance mechanisms that are conducive to limiting the opportunities for misconduct. The microprudential work of the European Supervisory Authorities in this area, as well as their consumer-related work, is thus welcomed.
- (b) A number of steps are needed at the international level to improve coordination between the relevant authorities. This would be best achieved through discussions in an international forum, such as the FSB, the Basel Committee on Banking Supervision and IOSCO. The aim of these discussions should be to ensure improved coordination and transparency between authorities. Devising an internationally agreed set of best practice principles for authorities to follow in cases where actions taken against a bank for misconduct in one jurisdiction may have systemic implications in other jurisdictions would be useful here.
- (c) The Legal Entity Identifier Regulatory Oversight Committee should give further consideration to the idea of extending the LEI scheme to a wider range of counterparties or perhaps providing more detail on the counterparty involved. This may not be sufficient to solve all problems, but could help towards managing misconduct risks better. For example, it would become easier to clarify which entities are subject to financial sanctions and should thus be avoided by banks. Also, it would help banks compile and manage lists of higher-risk entities.
- (d) Competent authorities should ensure that SREP assessments of misconduct risk take into consideration the systemic impact, i.e. the likely threat to the financial system arising from any potential misconduct issues at a bank. Should this risk be deemed material, competent authorities can apply Pillar 2 measures, such as requiring a strengthening of governance and internal control arrangements or a capital add-on to cover future misconduct-related costs, in line with the EBA's SREP guidelines.
- (e) Misconduct risks should be adequately captured in future EU-wide stress tests. In order to ensure a robust, rigorous and comparable assessment, the EBA, in cooperation with the ESRB, should devise a minimum methodology for banks to apply when calculating potential misconduct costs under stress. This methodology should aim to take into account all factors, including financial and macroeconomic factors, which may influence the timing and magnitude of misconduct cases. It should also require the consideration of idiosyncratic shocks. For assurance, supervisors should have the discretion to challenge these calculations, but sensitive supervisory information should remain confidential. In addition, policy-makers should ensure that banks perform an adequate assessment of misconduct risks (possibly also including indirect contagion effects) in their ICAAP stress testing, and microprudential supervisors should be able to question these estimates as well as the models used.

---

#### Box

#### The response of relevant international bodies

In January 2015 a draft version of this report was submitted to three international bodies which are relevant for addressing the systemic risks related to misconduct in the banking sector: the Financial Stability Board, the Basel Committee on Banking Supervision and the Legal Entity Identifier Regulatory Oversight Committee (LEIROC).

The FSB has welcomed the report. In particular, it has committed to examine:

- (a) whether the reforms vis-à-vis incentives, for instance regarding risk governance and compensation structures, are having a sufficient impact on reducing misconduct and whether additional measures are needed to strengthen the disincentives for improper behaviour;
- (b) the progress of ongoing reforms to benchmarks, and whether steps are needed to improve global standards of conduct in the fixed income, commodities and currency markets;
- (c) the extent of potential withdrawal from correspondent banking, its implications for financial exclusion, as well as possible steps to address this issue, i.e. together with the World Bank and other relevant bodies.

Meanwhile, the BCBS is moving forward with its work on misconduct risk in the Corporate Governance Task Force and the Policy Development Group. The revised Principles of Corporate Governance for banks, recently approved by the Committee, explore the role of the board and in general of banking governance in tackling misconduct risk.

The Chair of the LEIROC commented favourably on the report in a letter to the Chair of the ESRB dated 25 February 2015.

---

© European Systemic Risk Board

Postal address

60640 Frankfurt am Main  
Germany

Telephone

+49 69 1344 0

Website

[www.esrb.europa.eu](http://www.esrb.europa.eu)

All rights reserved. Reproduction for educational and non-commercial purposes is permitted provided that the source is acknowledged.

ISBN 978-92-899-1938-8 (online)

EU catalogue number QB-04-15-451-EN-N (online)

Digital object identifier: 10.2866/136216 (online)