



ETHICS AND INCENTIVES **in the Financial Industry**

Udo Philipp – January 2019

www.udo-philipp.de
www.finanzwende.de



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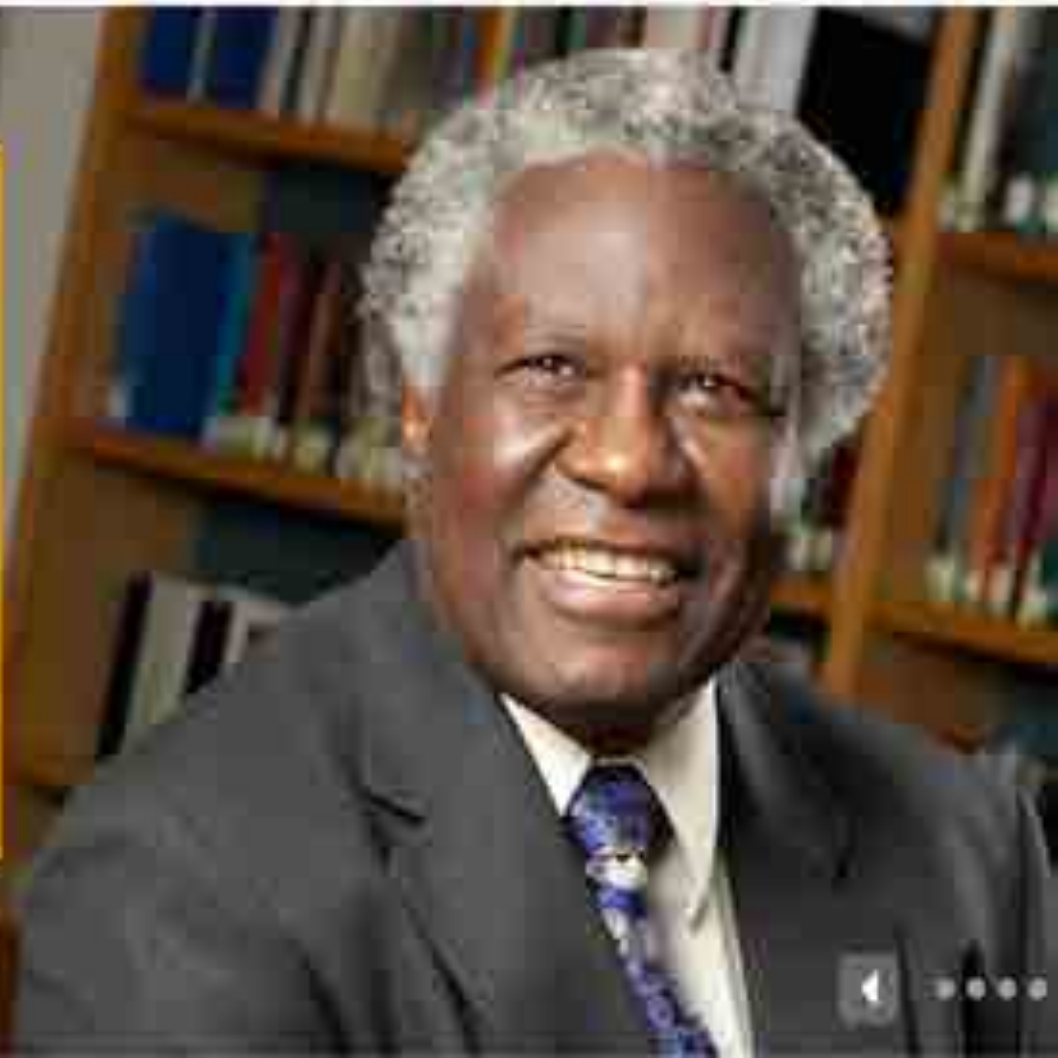
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Calistus Ijoma is named among the 100
Most Influential Africans for 2016.

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HERZLICH WILLKOMMEN
bei Europas führender nachhaltige
Nachhaltigkeitsbank.



Denn Geld kann so viel mehr.

Gemeinsam für die Finanzwende!

Über Jahrzehnte hat sich die Finanzindustrie immer mehr Einfluss erkauft. Gleichzeitig weichen ihre kurzfristigen Profitinteressen zunehmend von gesamtgesellschaftlichen Zielen ab. Um dieser Entwicklung entgegenzutreten, rufen wir dazu auf, eine Finanzwende einzuleiten.

Werden Sie Teil der Finanzwende: Tragen Sie sich in den Newsletter ein, werden Sie Fördermitglied oder unterstützen Sie unsere Kampagnen. Nur wenn wir viele sind, werden wir unsere gemeinsamen Ziele erreichen!



Mach mit!

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Giegold / Philipp / Schick

FINANZ WENDE

Den nächsten Crash
verhindern



Politik bei Wagenbach

Loss of confidence



A large, thick red line graph is superimposed over a cityscape. The line starts at the top left, fluctuates slightly, and then plunges steeply downwards, ending in a sharp arrowhead pointing into a dark, cracked asphalt street. In the background, several modern skyscrapers are visible under a cloudy sky. The overall scene suggests a catastrophic economic event.

392 BN EUROS
Just in Germany



Doom Loop



FEAR

of a Euro Exit

Sudden Stop





UNEMPLOYED

THE POPULIST TEMPTATION

ECONOMIC GRIEVANCE
AND POLITICAL REACTION
IN THE MODERN ERA

BARRY
EICHENGREEN





34.019 PAGES
of regulation since 2010



**Banco Popular – Banca Monte dei Paschi –
Veneto Banca – Banca Carige**

Who will be next?

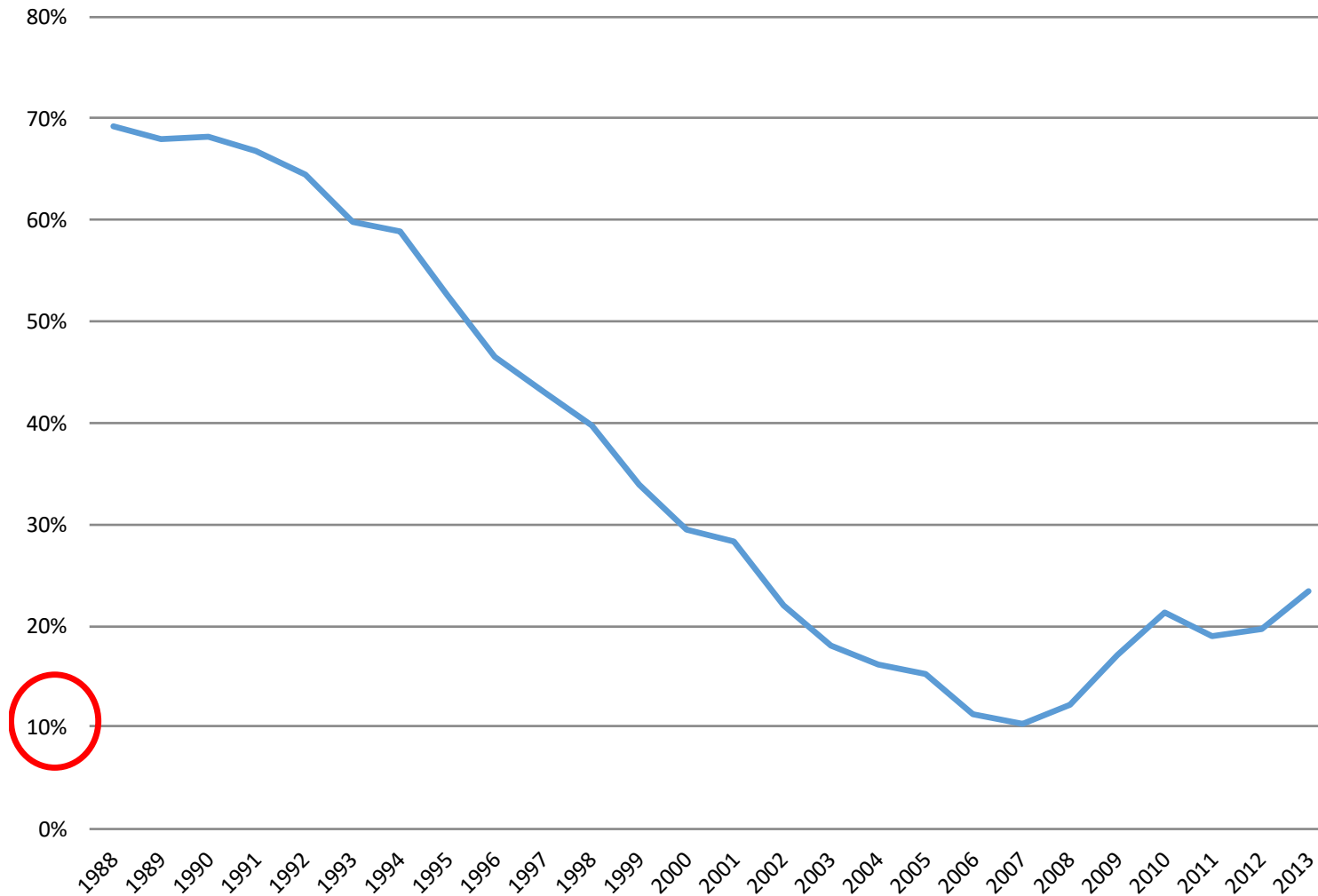
Banks have changed fundamentally

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Loans as percentage of total balance sheet at Deutschen Bank

Banks have changed fundamentally

Loans as percentage of total balance sheet at Deutschen Bank



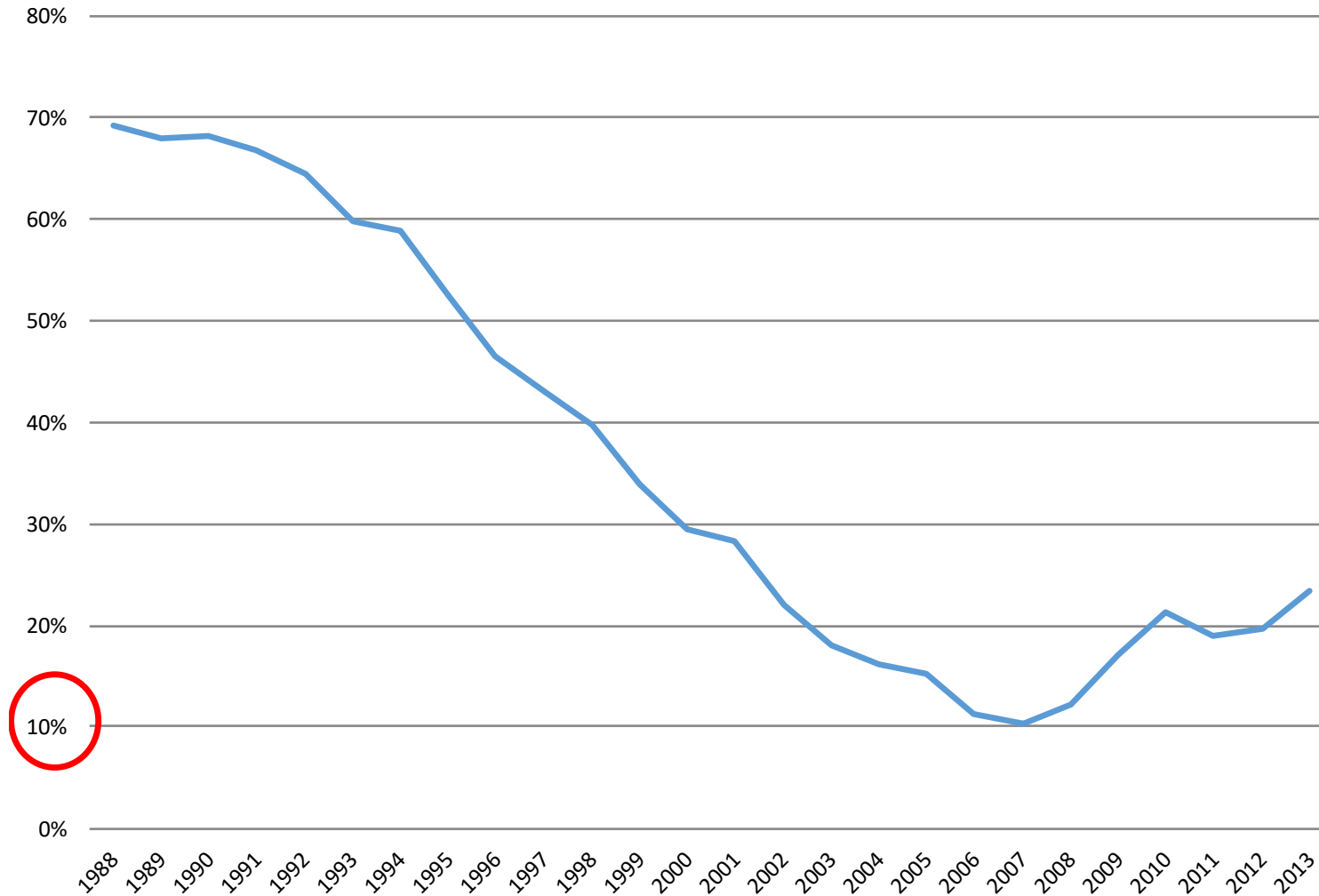
Quelle: Deutsche Bank, Geschäftsberichte 1989-2013. Eigene Darstellung.

Banks have changed fundamentally

Loans as percentage of total balance sheet at Deutschen Bank

CAGR 1987-2007:
loans

3,6% = x 2



Quelle: Deutsche Bank, Geschäftsberichte 1989-2013. Eigene Darstellung.

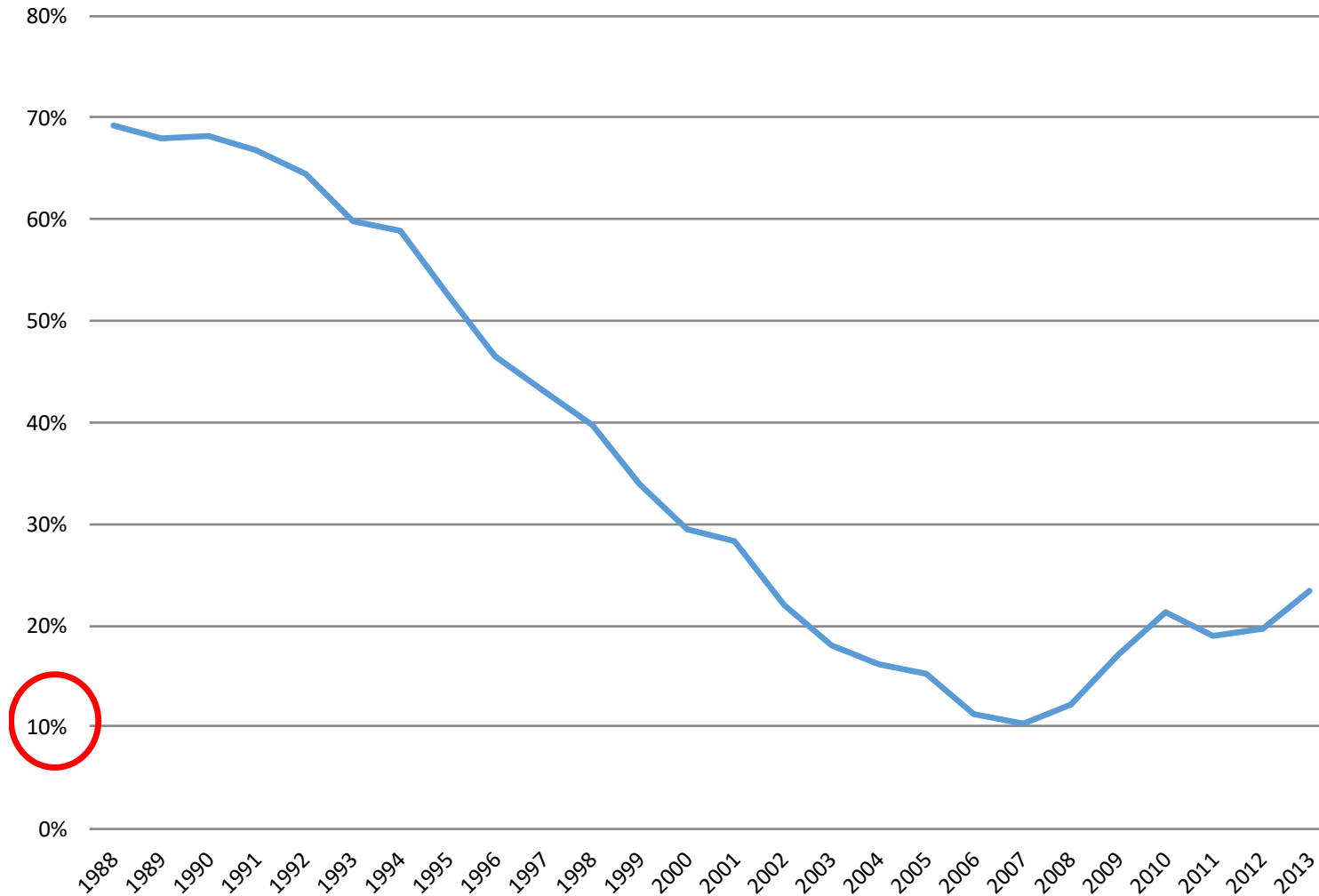
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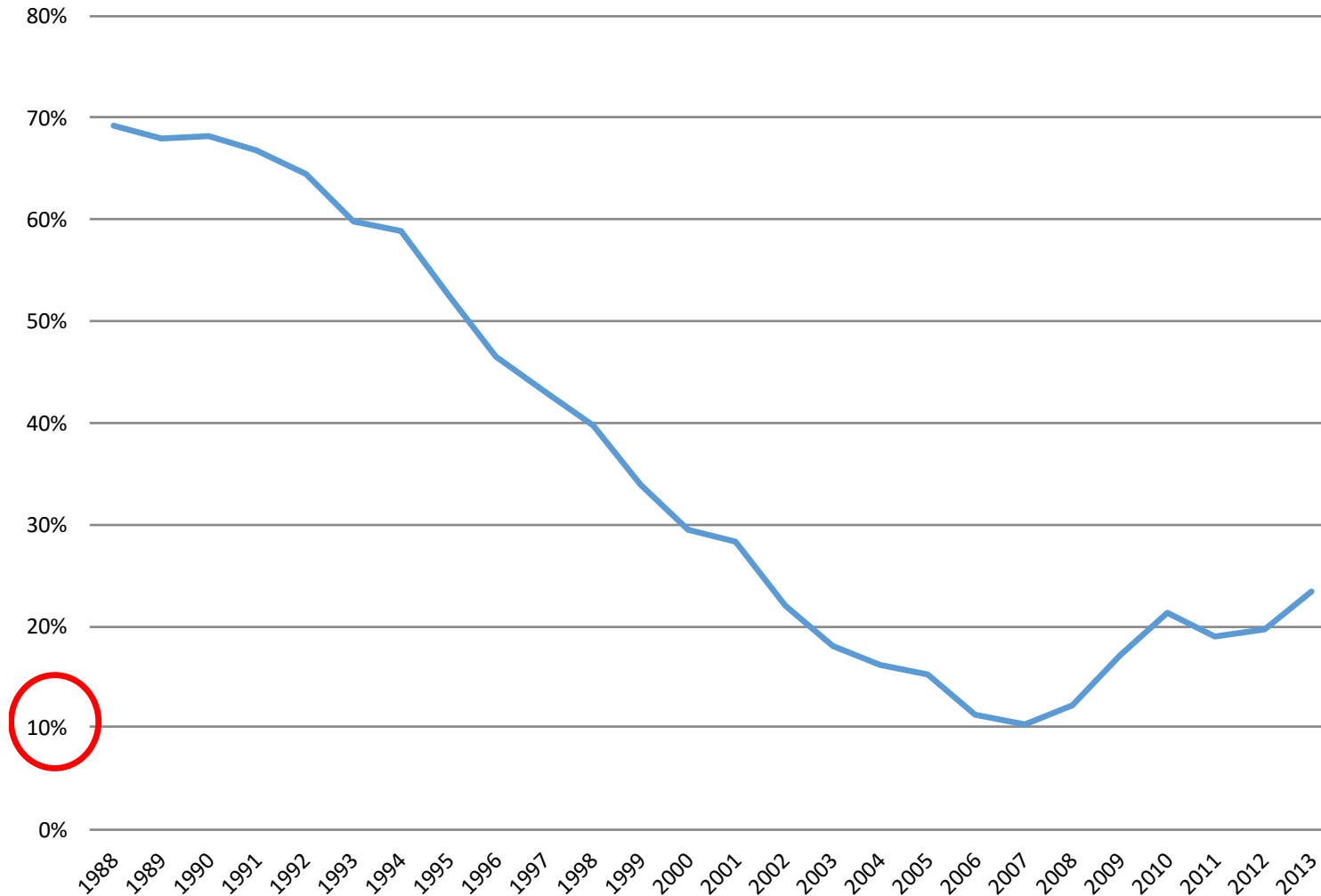
Balance sheet 14,4% = x15



Quelle: Deutsche Bank, Geschäftsberichte 1989-2013. Eigene Darstellung.

Banks have changed fundamentally

Loans as percentage of total balance sheet at Deutschen Bank



Quelle: Deutsche Bank, Geschäftsberichte 1989-2013. Eigene Darstellung.

CAGR 1987-2007:

loans 3,6% = x 2

Balance sheet 14,4% = x15

assets

- trading book
- derivatives

liabilities

- *wholesale financing*
- Repos

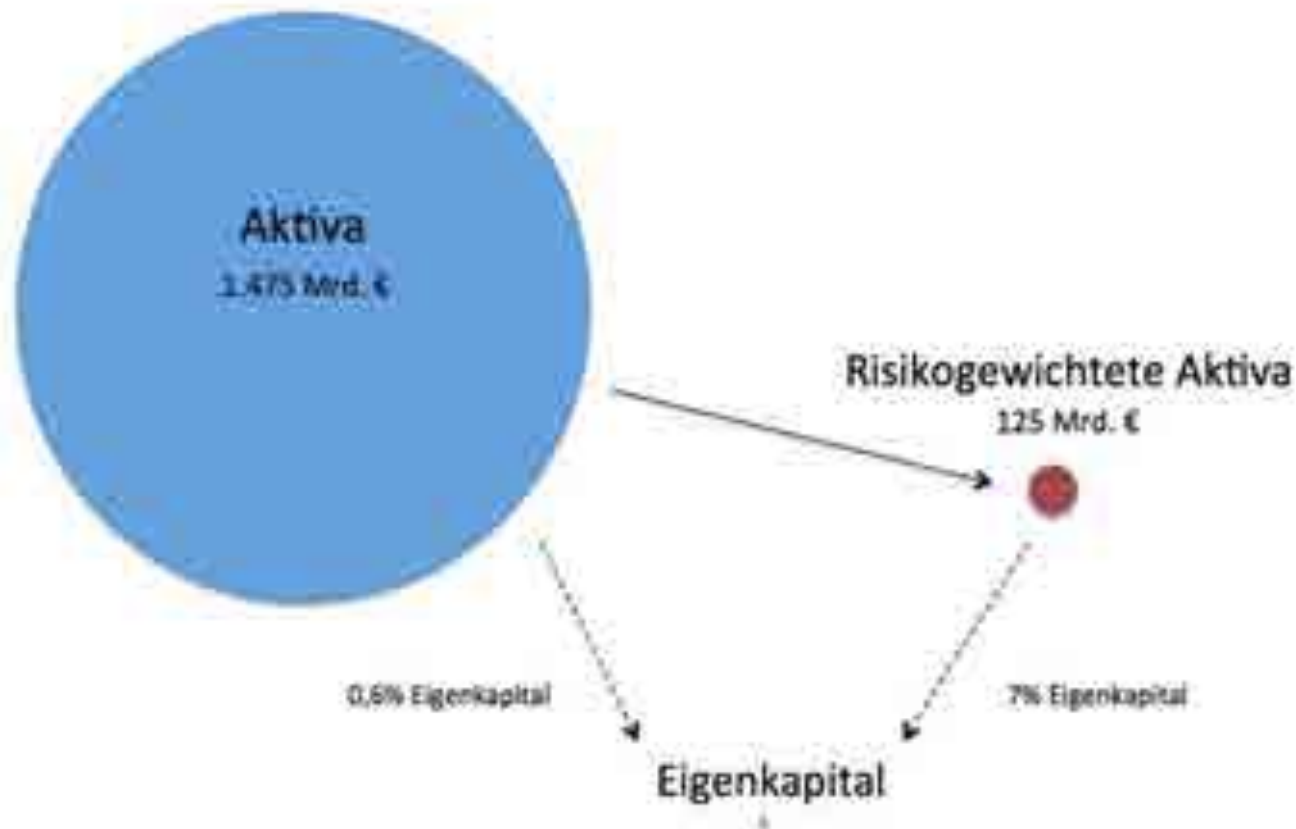
Also Goldman Sachs got only 10% of income from IPOs

Banks: extremely levered hedgefonds

Regulatory capital requirement

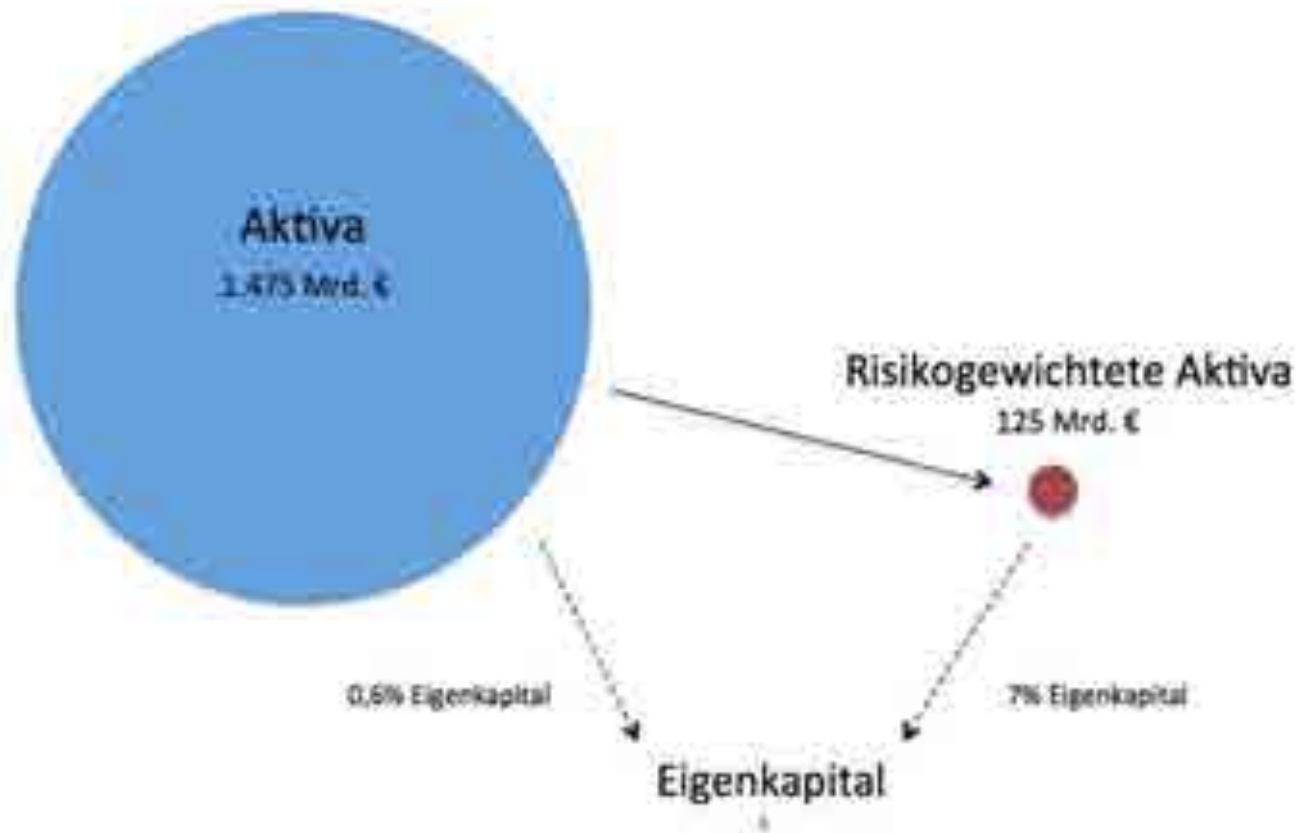
Banks: extremely levered hedgefonds

Regulatory capital requirement



Banks: extremely levered hedgefonds

Regulatory capital requirement



HypoRealEstate in 2007 had capital of only

0,08%

Quelle: Udo Philipp, Untersuchungsausschuss HypoRealEstate, Juli 2015, S. 4

<http://udo-philipp.de/wp-content/uploads/2016/08/HypoRealEstate.pdf>

Cf also:

Anat Admati und Martin Hellwig,
Bankers new clothes

Exploding finance



Cf. recent books:

John Kay, *Other People's Money – Masters of the universe or servants of the people?*

Adair Turner, *Between Debt and the Devil – Money, credit and fixing Global Finance*

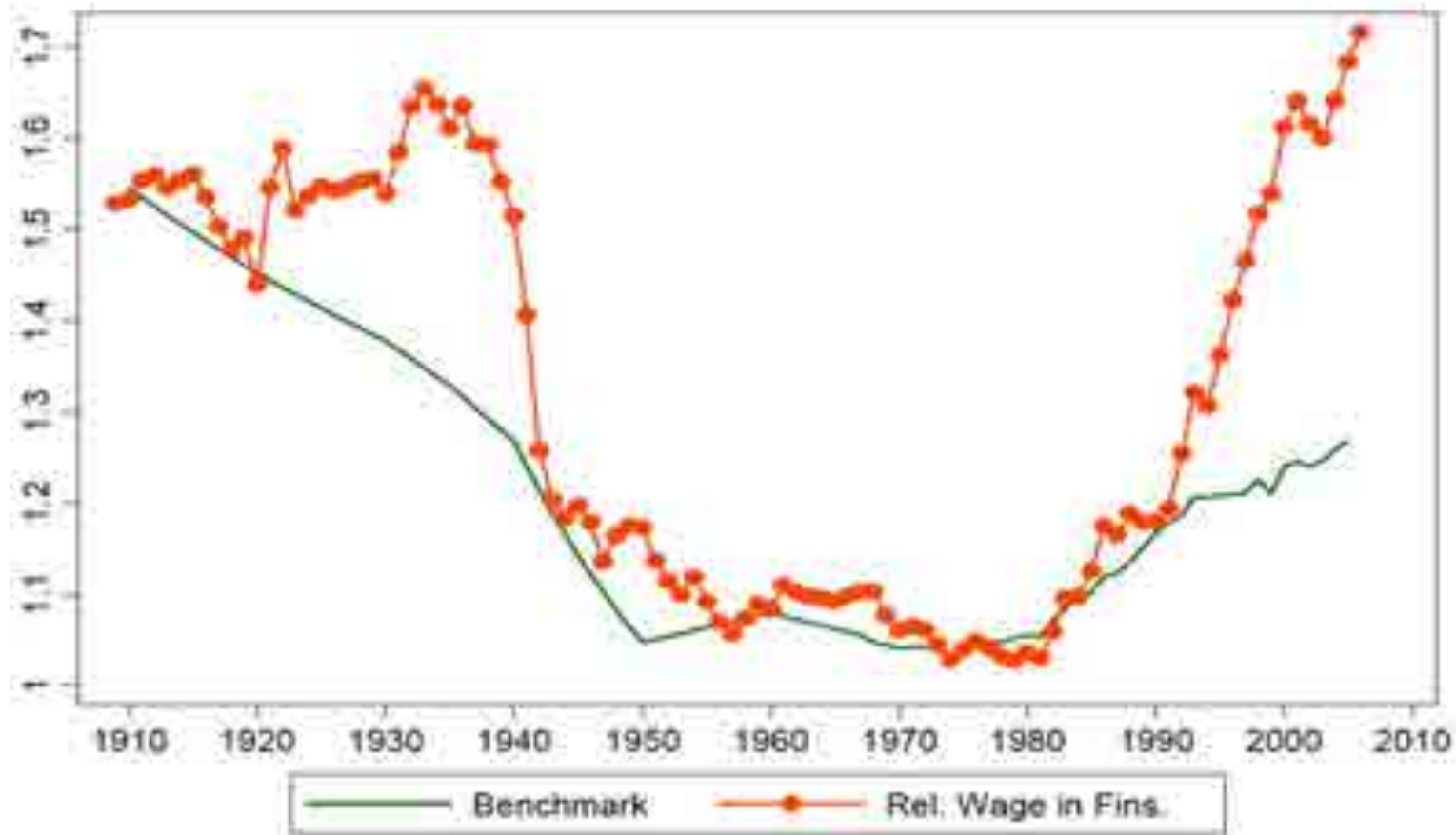
Martin Wolf, *The Shifts and the Shocks – What we've learned and have still to learn from the financial crisis*

A close-up photograph of a middle-aged man with short, light-colored hair, smiling broadly. He is wearing a dark suit jacket over a white shirt. The background is blurred, suggesting an outdoor setting. A red rectangular box is superimposed over the upper portion of the image, containing yellow text.

**„I am making certainty not less than
1 Million Euros“**

Exploding compensation

Figure 10: Actual and Benchmark Relative Wages in the Financial Industry



source: Philippon&Reshef (2009), Wages and Human Capital in the U.S. Financial Industry, 1909-2006

Scandals

- Libor
 - Rate rigging
- Payment protection insurance
 - Miss-selling of so called insurance ripping of poor consumers
- Cum-Ex
 - Ripping of the state

Scandals 2

- Mis-selling of payment protection insurance
- Mis-selling interest rate swaps
- Mis-selling credit card theft insurance
- Mis-selling of mortgage-backed securities
- Mis-selling of municipal bond investment strategies
- Mis-selling of structured deposit investments
- Mis-selling of foreign exchange products
- Fraud related to the packaging and selling of mortgage-backed securities that institutions knew to be “toxic waste”
- Misleading statements to investors involving capital-raising rights issue
- Misleading investors in the sale of collateralised debt obligations
- Abusive small business lending practices
- Predatory mortgage practices
- Abusive or in inappropriate foreclosure practices (Wells Fargo among others:
- Abusive imposition of unwarranted fees and charges
- Conducting false appraisals and charging customers for them
- Aiding and abetting tax evasion
- Aiding and abetting money laundering for violent drug cartels
- Violations of rogue-regime sanctions
- Manipulation of Libor
- Manipulation of Euribor
- Manipulation of FX markets
- Manipulation of gold fixing (London)
- Manipulation of commodity markets via metals warehousing practices
- Manipulation of electricity markets (California)
- Manipulation of the swaps market benchmark index (Isdafx)
- Collusion relating to credit default swap market dealing in violation of US anti-trust laws (“settlement” reached with authorities to resolve allegations)
- Filing false statements with the SEC (London Whale)
- Keeping false books and records (London Whale)
-

Source:

BETTER MARKETS:

<https://www.bettermarkets.com/sites/default/files/Speech%20Berlin%20Financial%20Stability%20Conf%20Nov%202016.pdf>

Scandals 3

- Reporting failures relating to Madoff
- Withholding of critical information from Italian regulators
- Bribing civil service employees in Japan
- Mis-reporting related to Barclays emergency capital raising
- Stealing confidential regulatory information by a banker
- Collusion with Greek authorities to mislead EU policy makers on meeting Euro criteria
- Financial engineering with the aim of moving Italian debt off-balance sheet
- Manipulation of risk models with the aim of minimizing reported Risk Weighted Assets / capital requirements
- Electronic FX trading related market manipulation
- Process and control failures with respect to dealings with the ultra-wealthy/ “politically exposed persons”. (*Elephant Deal* - Barclays 11/’15)
- Failure to prevent bribery of African officials (Standard Chartered)
- Peddling complex tax avoidance strategies to corporate clients (Deutsche)
- Improperly providing information about a Japanese company to its clients (Deutsche)
- Abuses relating to dark pool trading platforms (Barclays)
- Failure to disclose conflict of interests to wealth management clients (JPM)
- Misleading investors with wrong / incomplete information (JPM London Whale losses)
- Conspiracy to commit multi-million dollar securities fraud (RBS:
- Overcharging customers for FX transactions (Barclays: Times / Oct 30, 2015)
- Failure to meet the terms of the 2013 Mortgage foreclosure abuses settlement (JPM)
- Repeated violation of federal laws connected with sourcing securities for client shorting (GS)
- Manipulation of Korean stock market
- Unfairly jumping the creditor queue to secure (confiscate?) collateral relating to Lehman
- Publishing research and trading in the shares of a company it was advising (Goldman Sachs)
- Other mortgage related abuses including: failing to accurately track payments by borrowers; charging unauthorised fees; and providing false and misleading information in response to complaints by customers. (HSBC)
- Use of minority owned non consolidated subsidiaries to arbitrage capital requirements
- Investment bank analysts altering stock research recommendations to curry favour with companies they were researching. (Deutsche Bank / Feb17)
- Use of illegal offshore schemes to avoid paying income tax on bonuses (Deutsche/UBS)
- Ex Federal Reserve employee working at Goldman conspired with former Central Bank colleague to leak confidential information

Scandals 4

- Overcharging custody clients through the use of undisclosed or secret mark-ups on foreign exchange transactions in contradiction of its promise to clients of “best execution rates.” [State Street settles allegations for \$530mio. – July 28]
- Mis-selling of loans to small business customers under the UK’s Enterprise Finance scheme [RBS]
- Offers to procure prostitutes to curry favour with SWF clients [GS/Libyan SWF]
- “Manufactured euros 7.2 billion euros of deposits by sham transactions to inflate reported deposit base during the crisis [Ireland]
- Predatory practices connected with the issuance of banking debit cards
- Supervisory failures connected with Chicago Mercantile related exchange and clearing fee processing which in turn involved overcharging of customers [Merrill Lynch and Barclays Capital US/CFTC fines]
- Falsifying accounts (manipulating mark-to-market pricing of derivatives positions) to reduce reported unrealised losses [Deutsche]
- Dismissal of whistle-blower who complained about the above [Deutsche]
- Creation of fake client accounts and making unauthorised transfers to achieve bonus driven sales targets - involving *some 2 million clients* and no less than 5000 employee offenders over some 5 years (Wells Fargo)
- Misleading investors via misclassification of private client asset accounts with a view to inflate reported Net New Assets for the bank. *And currently under investigation...*
- Manipulation of precious metals markets (gold/silver/platinum/palladium - Switzerland)
- Manipulation / collusion of the US Treasury Market auction/client sales
- Manipulation of energy markets
- Short changing clients a second time in not paying settlements in full
- Violations connected with emergency fund raisings
- Falsifying customer data and records
- Misleading shareholders ahead of RBS rights issue
- Misleading shareholder information with respect to Lloyds takeover of HBOS
- Conspiracy to force small businesses into bankruptcy to the benefit of the lender
- Insertion of illegal rate floors in Spanish mortgage lending
- Faking customer files to justify predatory foreclosure practices
- Misleading profit and capital statements based on questionable accounting practices
- Bribing (“Improper payments”) officials in connection with license applications in Saudi Arabia
- Hiring sons and daughters of senior officials in return for favours
- Fabricating complaint letters after the fact to justify dismissal of a whistle-blower who raised alarms over possible mis-selling of mutual funds.
- “Mis-informing” (lying) to 4500 people over existence of dormant accounts
- Use of “mirror trades” (\$10 billions worth) to circumvent Russian related sanctions (Deutsche)
- Overcharging customers who are past due on their credit cards (HSBC: 14 Dec / Times)

Scandals 5

- Market rigging of Gilt trading (Lloyds/CS)
- Hiding failed Loans in its commercial real estate portfolio in 2009. 2010 at a time of issuing new stock to repay government bail-out money. Wilmington Trust, Delaware.
- Non transparent and excess charges for FX transfers by major UK banks to small businesses in the UK:
- Manipulating shareholdings around dividend payment dates to trigger dishonestly acquired tax reimbursements. (DB/Barclays/BNP/GS/UBS)
- Manipulation of the Australian “bank bill swap rates”
- Manipulation of the government sponsored bond market (supranational, sub-sovereign and government agency debt or “SSA market.”)
- Use of secret / undisclosed payments of circa \$500mio connected with emergency capital funding. (Barclays)
- Knowingly acquiring “dirty debt” (a loan used as part of a multi-million pound embezzlement scheme) and using it to demand compensation from an African government (Standard Chartered)
- Conspiracy with borrower to falsify work estimates totaling \$400 million of fraudulent accounts receivable: (Citibank)
- Facilitating fraudulent activity by customers via use of import advance payments (Barclays)
- “Spoofing” in trading of US government bonds (Barclays)
- Laundering the proceeds of Petrobras related corruption (HSBC)
- Mis-selling of “lobo” loans to UK Local Councils
- Fraud and Criminal mismanagement in connection with account management for the former prime minister of Georgia (Credit Suisse Geneva)
- Forcing customers to switch from variable (“tracker”) mortgages into fixed rate mortgages – in a falling / low rate environment. [Ulster Bank-RBS]
- Mis-selling expensive life insurance products to little old ladies in France (Barclays France)
- Facilitating African money laundering on a grand scale (Barclays France)
- Misleading Libor submissions with the aim of boosting confidence in the bank’s perceived credit worthiness (Citi)
- Conspiring to facilitate VAT evasion through manipulative carbon trading transactions (RBS 6/2016)
- Misleading inexperienced officials in nascent Libyan SWF into complex and ultimately loss making derivative trades (Goldman Sachs)
- Mishandling of the proceeds of securities offerings for a state investment fund (Goldman Sachs/IMDB)
- Offering for use, false and misleading valuation opinions on M&A transactions to curry favour with wealth management clients (Goldman Sachs)
- Abusive practices in handling mortgage arrears (Lloyds / 29 July)
- Errors and abuses connected with reverse mortgages and related foreclosures in NY State [NY DFS investigation of Reversed Mortgage Solutions and Champion Mortgage]
- Manipulation of Australian Bank Bill Swap Rate – BBSW. [Lloyds/RBS/HSBC/JPM/MS/UBS/DB/others]
- Forging client signatures to create unwanted credit card account and then harassing the individual for non payment of charges relating to a card never applied for (Wells Fargo)
- Dismissing employees who failed to make their sales targets through fraudulent behaviour [Wells Fargo]
- Forcing distressed banking clients to hire a turn-around consultant who recommended expensive new lending facilities and from whom the banker received personal kickbacks
- Collusion to falsify accounts of Italy’s third largest bank.

Abacus scandal – facts

- Hedge fund Paulson asked Goldman Sachs to assemble CDOs (Abacus) with subprime mortgages in exchange for a fee of \$15m
- Abacus was bought by German bank IKB
- Paulson shorted Abacus by buying CDS
- Abacus lost \$900m, IKB lost \$150m
- IKB went bankrupt
- Paulson made a gain of \$1bn

Abacus – ethical issues

Conflicts of interest

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- Agency theory: Serving the interest of the bank and of the client
 - Reputation
 - Repeat transactions
 - Incentive structures: only make money if client makes money

Abacus – ethical issues

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 - Paulson and IKB
 - Typical for I-Banks to have “chinese walls”
 - Work for seller and buyer (arrange financing) at same time
 - Maybe not at same time but have one regular and large client and a one-off small client

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- Truth telling and transparency
 - Does it work with unsophisticated customers?

CONFLICTS OF INTEREST

- ^ I-Banking
- ^ Rating Agencies
- ^ Retail Banking



A man in a dark suit, white shirt, and dark tie stands next to a dark green car. He is wearing sunglasses and has his arms outstretched in a celebratory gesture. The background is a warm, golden-hour scene with trees and a building.

BONUS TIME!

**Christian Bittar (Deutsche Bank):
Libor Rigging**

147m Euros Bonus

Equity based compensation does not help

- Evidence that banks with CEOs whose incentives were better aligned performed worse
 - Cf. Fahlenbrach and Stulz, Bank CEO incentives and the credit crisis, Journal of Financial Economics, 2011
- Top managers could cash out even with share based pay
 - Cf. Bebchuk, Cohen, Spamann, The wages of failure: executive compensation at Bear Stearns and Lehman 2000-2008, Yale Journal on Regulation, 2010
 - Shareholders had negative cumulative return
 - Top 5 executives lost \$800m and \$600m
 - But cashed out \$1.4bn and \$1bn, so net profit of \$600m and \$400m

The magic of debt and limited liability



Problem highly levered banks

- Debtholders do not prevent high leverage
 - Deposits insured
 - Wholesale financing
 - Very short term debt
 - Repo (fully secured financing)
 - TBTF guarantee
 - TBTF subsidies 200bn Euros p.a. in Europe

Source: IMF, Global Financial Stability Report, April 2014

Does banking culture lead to dishonesty?

Study in Journal Nature

- 200 bank employees assigned to two groups
 - Bank group: participants had to talk about their banking jobs
 - Control group: talk about private life
- Test: participants could make lot of money by cheating
- Control group: honest on average
- Banking group: significantly less honest
- Control study with other professions: no significant results

Recent measures

- Bonus cap
 - 2x base salary has been decided
 - Better would be: high compensation deferred over 10 years
- More equity
 - 3% leverage ratio better than 2%, but still homeopathic dose
- Structural reform (implemented only half heartedly)
 - Do not subsidize trading with insured deposits
 - Easier to resolve
 - Shrink economic rents in I-Banking

A close-up photograph of a business meeting. Two people are seated at a table, their hands visible as they interact with a document. One person, wearing a dark suit, has their hand resting on the paper. The other person, wearing a light-colored shirt, is holding a pen and appears to be signing the document. The background is blurred, showing a window with a grid pattern. A green rectangular box with yellow text is overlaid at the bottom of the image.

Re-introduce liability

Reintroduce liability

- Investment banks used to be partnerships
 - Full personal liability of partners
 - i.e. private wealth on the hook
 - Goldman Sachs was partnership until 1999
- Criminal liability
 - UK Parliamentary Commission on Banking Standards
 - Senior Manager regime
 - Executive responsibility of systemic failure
 - John Kay “den of thieves”
 - Criminal offence to be in charge of a den of thieves not be a thief yourself



Who is leading the way?



better rules

less lobbying

tougher sanctions

Entrepreneurial risk in Private Equity vs short term bonus in banks

- Carried Interest in PE
 - Substantial private investment
 - Leads to high personal debts
 - High threshold – minimum return
 - 8% net after all cost
 - Fund carry: after 10-12 years
 - Investors have received all their money back including high minimum return
 - Low base salary
- Bonus/Stock option
 - No personal risk
 - No minimum return
 - Yearly pay out
 - Investors keep risk
 - High base salary

Triodos – ethical bank

- No bonuses
- Overall limit on pay
- Gender balancing
- Clear ethical standards

The Banker's Oath

Below is the text of the legally required Banker's Oath, taken by the approximately 87.000 bank employees in The Netherlands. Aside from personally signing the oath's form, employees committed themselves personally by participating in a special ceremony arranged by their employers. Those who commit themselves to the oath also adhere to the Code of Conduct.

I swear / promise that, within the boundaries of my function in the banking sector, I will:

- *Execute my function ethically and with care;*
- *Draw a careful balance between the interests of all parties associated with the business, being the customers, shareholders, employees and the society in which the business operates;*
- *When drawing that balance, making the customer's interests central;*
- *Will comply with the laws, regulations and codes that apply to me;*
- *Will keep confidential that which has been entrusted to me;*
- *Will not abuse my knowledge;*
- *Will act openly and accountably, knowing my responsibility to society;*
- *Will make every effort to improve and retain trust in the financial sector.*

So help me God! / This I pledge and promise!

Giegold / Philipp / Schick

FINANZ *WENDE*

Den nächsten Crash
verhindern



Politik bei Wagenbach