

A man in a dark suit is seen from behind, looking up at several tall, modern glass skyscrapers. The sky is filled with soft, white clouds, and the lighting suggests a bright day. The overall scene conveys a sense of ambition and the scale of the financial industry.

ETHICS AND INCENTIVES

In the Financial Industry

Udo Philipp – December 2017

www.udo-philipp.de

Loss of confidence



Sudden Stop

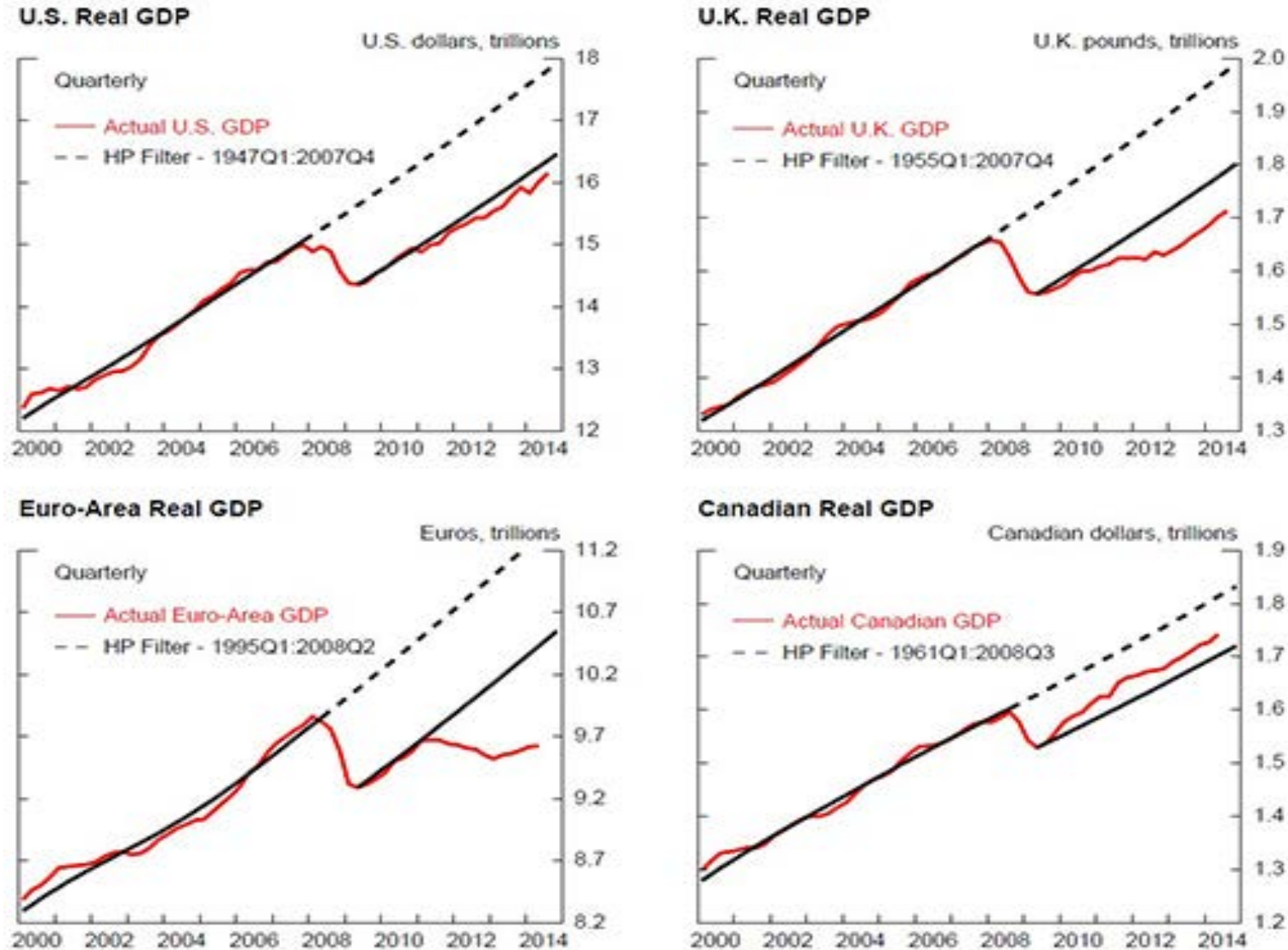




392 BN EUROS
Just in Germany

The real issue: persisting output gap

Figure 1



source:
Federal Reserve Nov 2014
Potential Output and Recessions:
are we fooling ourselves
Cf also Reinhart and Rogoff, This
time is different



34.019 PAGES
of regulation since 2010



Will they fall?



PRIVATE EQUITY?



GREED IS GOOD

[S](#)

GATEWAYS FOR:

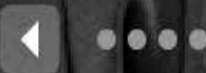
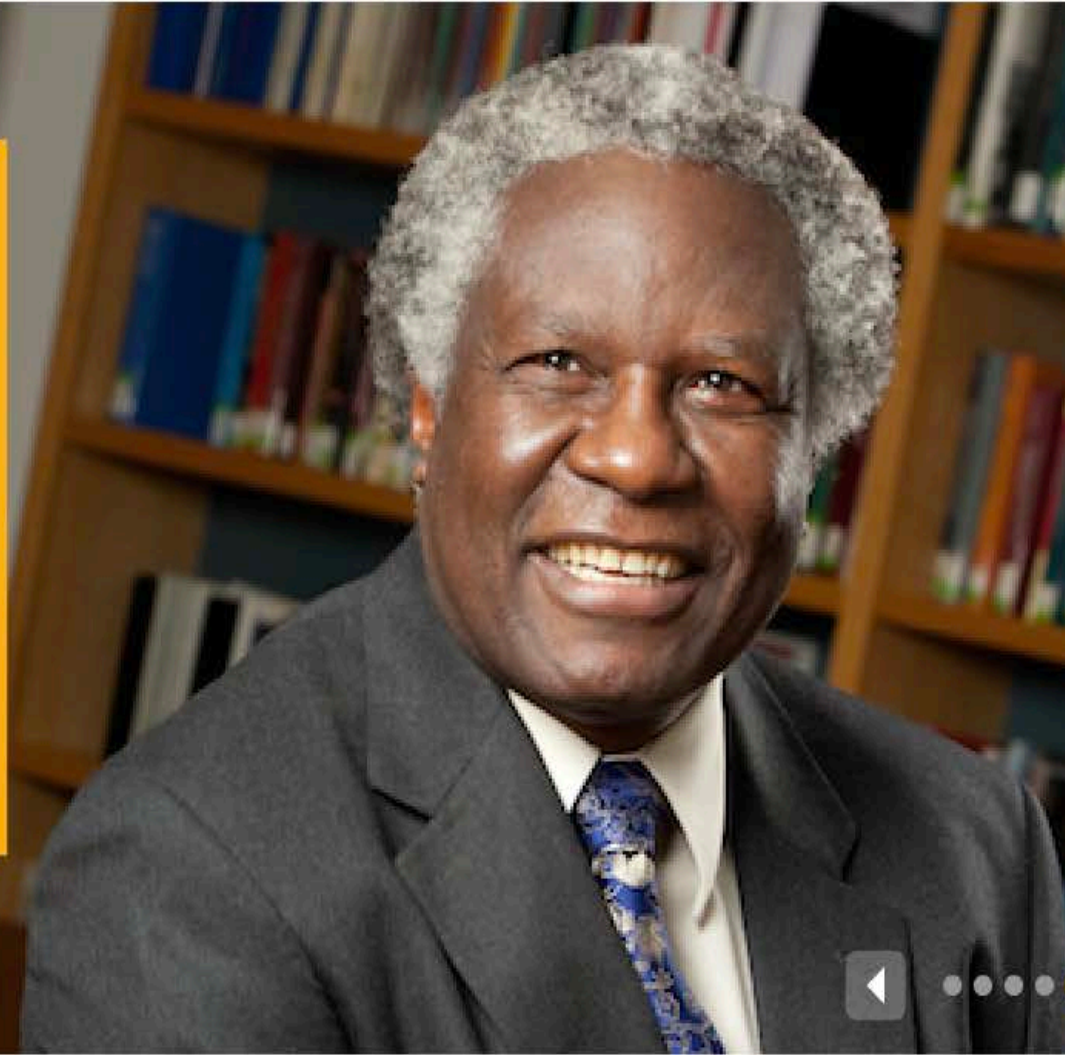
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**THE CAMPAIGN FOR
HARVARD KENNEDY
SCHOOL**

ASK WHAT YOU CAN DO TO INSPIRE CHANGE

Calestous Juma is named among the 100
Most Influential Africans for 2016.

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institut für finanzdienstleistungen e.V. (iff)



Das institut für finanzdienstleistungen e.V. (*iff*) ist ein unabhängiger, international ausgerichteter gemeinnütziger Verein, der im Bereich nachhaltiger Finanzdienstleistungen forscht und berät. Das Institut erstellt EDV-Programme für die Finanzberatung der Verbraucher, gibt Publikationen

heraus, wirkt bei der Fortbildung mit und entwickelt Modelle für sozial verantwortliche Kredite, Anlagen, Zahlungsverkehrsmittel und Versicherungen.

Ziel seiner Arbeit ist es, insbesondere die Interessen von Verbrauchern, Anlegern, Kleinunternehmern und gemeinnützigen Unternehmen optimal und wirtschaftlich verantwortlich in der Beziehung zwischen Kunde und Finanzdienstleister aufzuzeigen und einzubringen.

iff aktuell



Das war die **Int. Konferenz zu Finanzdienstleistungen 2016** in Hamburg

[mehr Informationen](#)

Der Termin der kommenden Konferenz: **11./12. Mai 2017**

Jan

11

Deutsche Bundesbank und iff starten Schülervorlesungen zum Thema Geld

HERZLICH WILLKOMMEN
bei Europas führender
Nachhaltigkeitsbank.



Denn Geld kann so viel mehr.

oekom
Impact Studie 2017



Giegold / Philipp / Schick

FINANZ *WENDE*

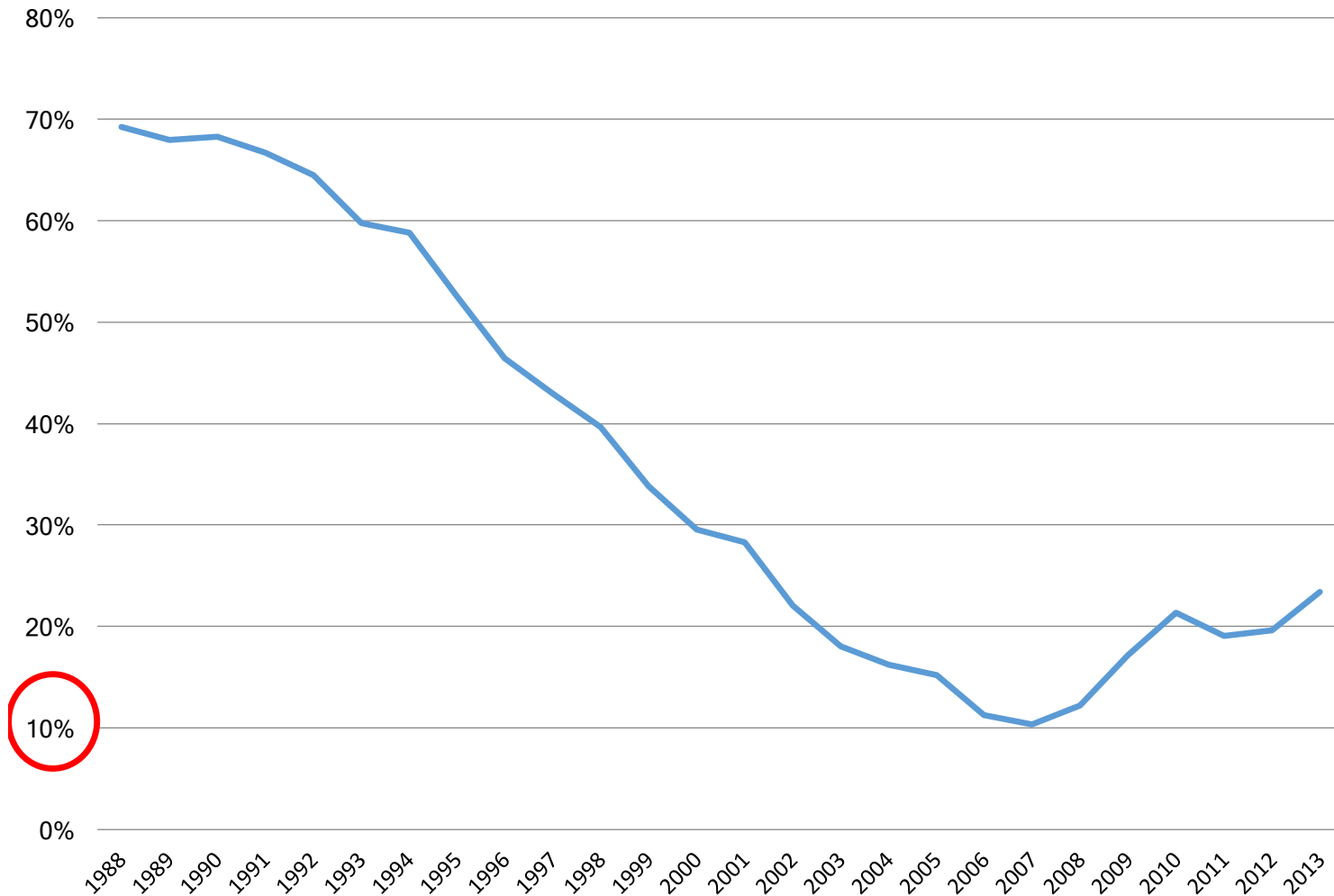
Den nächsten Crash
verhindern



Politik bei Wagenbach

Banks have changed fundamentally

Loans as percentage of total balance sheet at Deutschen Bank



CAGR 1987-2007:

loans 3,6% = x 2

Balance sheet 14,4% = x15

assets

- trading book
- derivatives

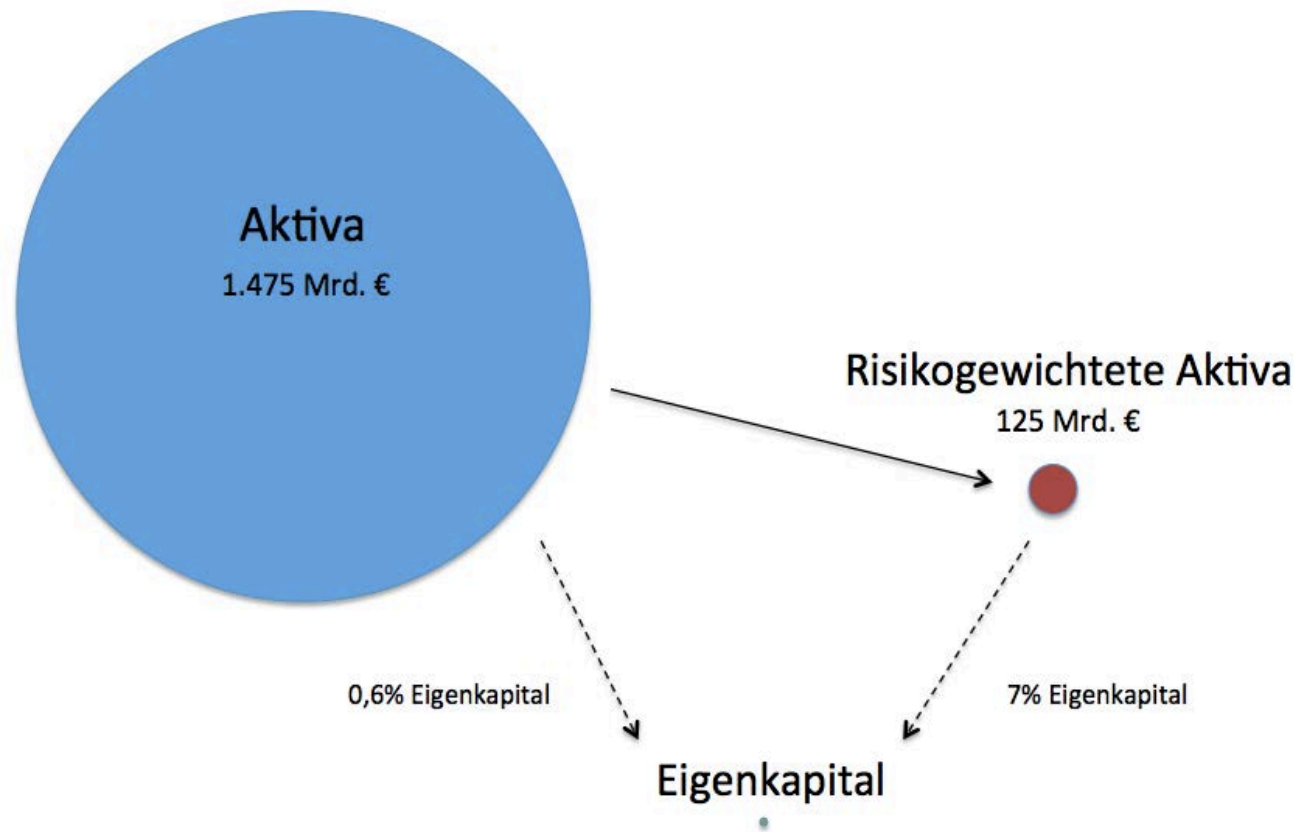
liabilities

- *wholesale financing*
- Repos

Also Goldman Sachs got only 10% of income from IPOs

Banks: extremely levered hedgefonds

Regulatory capital requirement



HypoRealEstate in 2007 had capital of only

0,08%

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

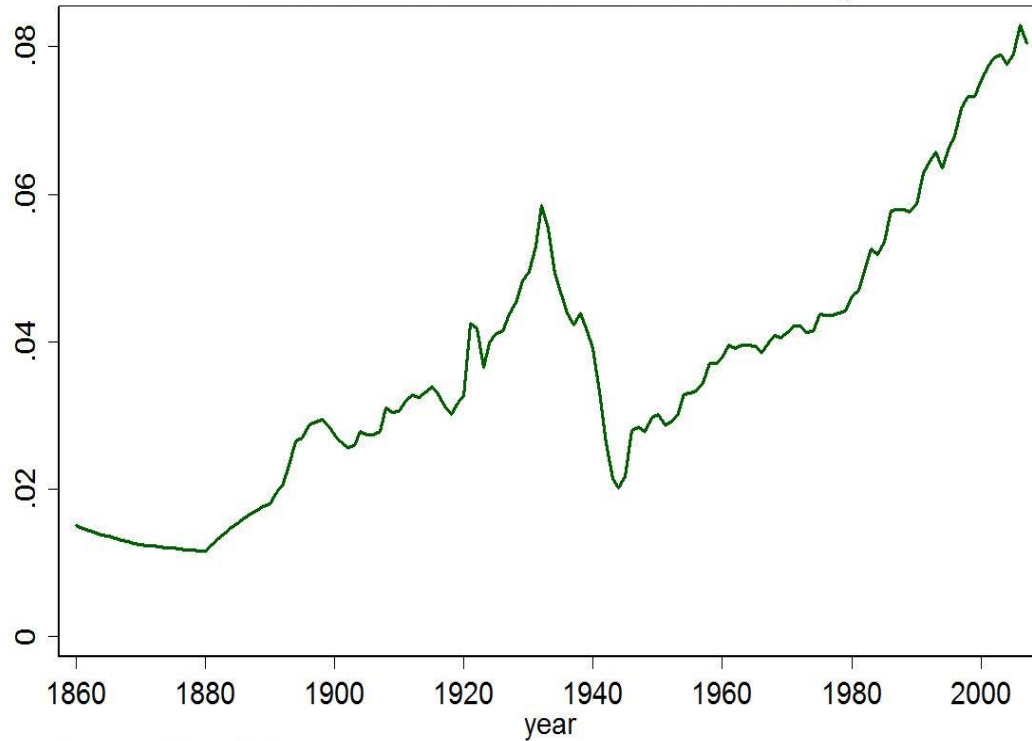
<http://udo-philipp.de/wp-content/uploads/2016/08/HypoRealEstate.pdf>

Cf also:

Anat Admati und Martin Hellwig,
Bankers new clothes

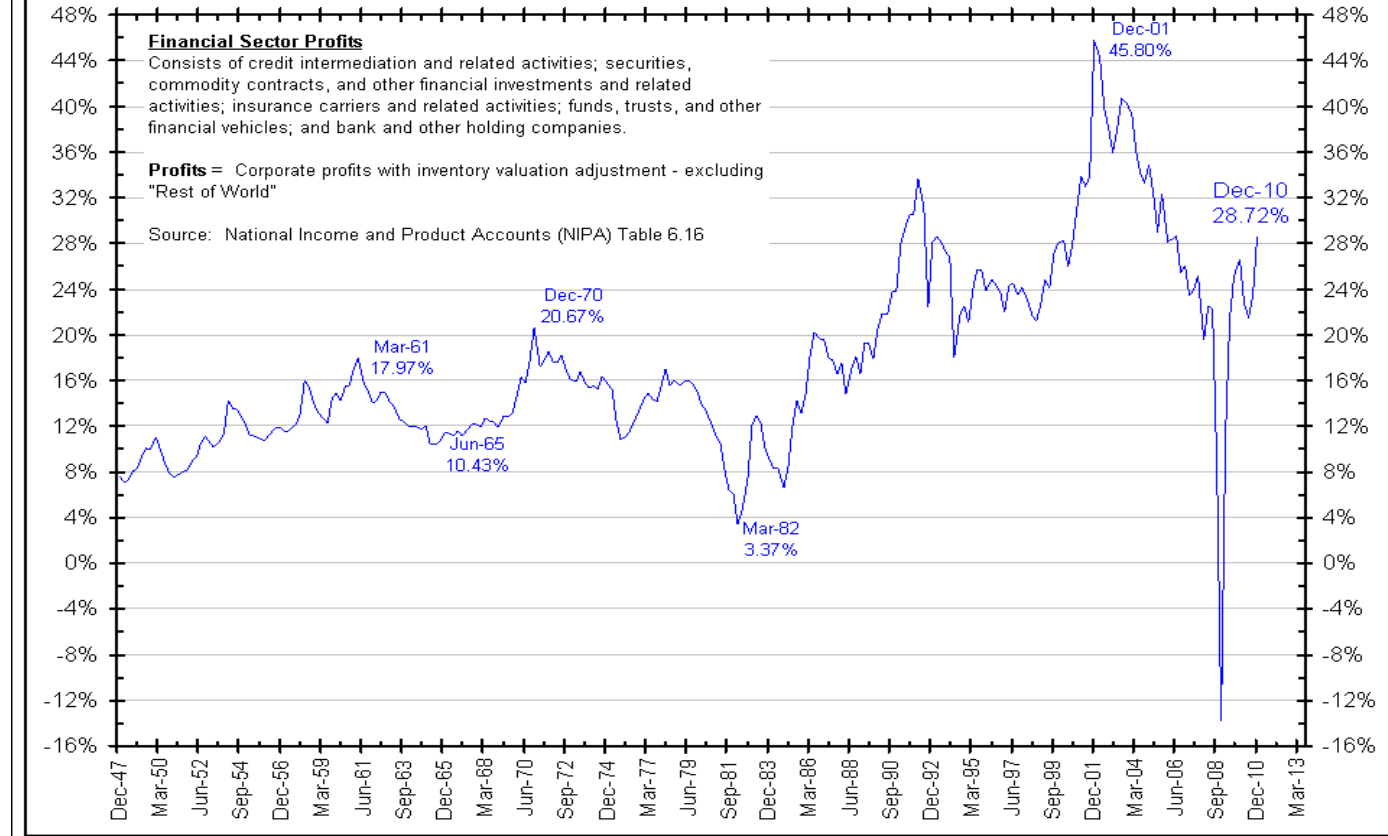
Exploding finance

GDP share of US Financial Industry



Source: Philippon, 2008

Financial Sector Profits As A % of All Domestic Corporate Profits



Cf. recent books:

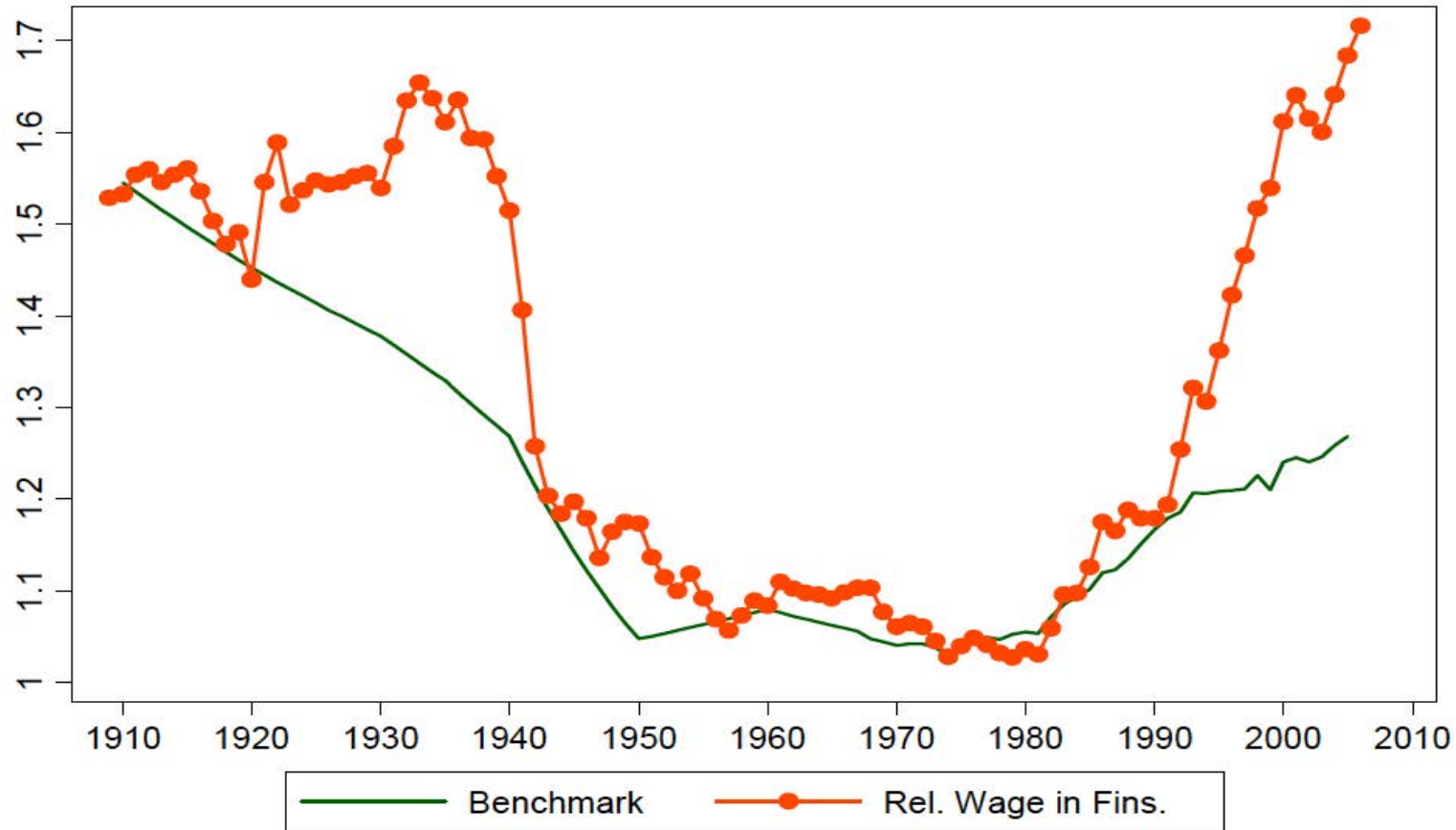
John Kay, *Other People's Money – Masters of the universe or servants of the people?*

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*

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 fixing
 - Libor is benchmark rate for almost all credit contracts
 - Major banks had to pay billions of fines
- Foreign exchange fixing
 - Traders rigged fx market to make profit
 - Banks paid billions in fines
- London Whale
 - 6.2 bn USD trading loss for JPMorgan

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 (Isdafix)
- 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 – agreed facts

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

Abacus – ethical issues

- Conflicts of interest
 - Agency theory: Serving the interest of the bank and of the client
 - Reputation
 - Repeat transactions
 - Incentive structures: only make money if client makes money
 - Serving two clients simultaneously
 - 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
- Truth telling and transparency
 - Does it work with unsophisticated customers?

Huge bonuses

- Tom Hayes (UBS): so far only person convicted for Libor rigging
 - 14 years prison
 - < 30 years old in 2008/09
 - Banks rivalled to hire him.
 - Goldman offered 3m sign on bonus
 - UBS paid stay bonus instead
- Christian Bittar (Deutsche Bank)
 - bonus: 84m Euros in 2008 and 63m Euros in 2009

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



The magic of leverage and limited liability - 1

- Invest 100 – return 150 – profit 50
- Take debt 100 – 40 interest – profit 10
- E.g. 1 equity financed and 49 debt financed: expected value $1 \times 150 + 49 \times 10 = 640$
- Risk: 50% chance of 150 and 50% chance of 120
 - expected value : $0.5 \times 150 + 0.5 \times 120 = 135$
 - $135 < 140$ so return is lower than what you need to pay back to the bank
 - In negative scenario: 20 profit on equity but loss of 20 with each debt financed bet
 - $1 \times 120 + 49 \times (-20) = -860$
 - Expected value $0.5 \times 640 + 0.5 \times (-860) = -110$
- Limited liability: you can only lose your equity, so max loss=100
 - If you invest 100 you have 50% chance of getting back your money plus profit and 50% chance of losing all
 - $.5 \times 640 + .5 \times 0 = 320$
 - It is rational to take 49 debt for such risky gamble

The magic of leverage and limited liability - 2

- Even extremely risky bets make sense with leverage
 - E.g. invest 100, 20% chance of getting 150 and 80% risk of losing all:
 - $.2 \times 150 + .8 \times 0 = 30$
 - The expected value of 30 is much lower than the 100 you need to invest. You would never invest to make such a big loss
 - But with debt you can only lose your equity
 - EV $.2 \times 640 + .8 \times 0 = 128$
 - Expected value of 128 is larger than the 100 investment. So it makes sense to invest
- Typical bet in financial industry: very high likelihood of low return and very low probability of very high loss
 - $.999 \times 10 + .001 \times (-100,000) = -90.01$
 - Negative expected value, nobody would invest
 - A bank needs 3% of equity, so the max loss would not be 100,000 but only 3,000. The outcome is positive, it makes sense to play this gamble
 - $.999 \times 3,010 + .001 \times 0 = 3,006.99$
- Stock options put leverage on leverage
 - No personal investment, only upside

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



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

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