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ANTI-CORRUPTION HELPDESK

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ANTI-CORRUPTION MECHANISMS IN THE BANKING SECTOR

QUERY

Please provide a short introduction to anti-corruption mechanisms which may curb corruption risks in the banking sector as well as recommended reading resources related to the issue.

PURPOSE

To provide background research for a policy brief on standard mechanisms to help the government strengthen banking transparency, integrity and stability in Afghanistan.

CONTENT

1. Corruption risks in the banking sector
2. Regulatory and non-regulatory tools to counter corruption and promote integrity
3. References and further reading

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Date: 13 August 2015

SUMMARY

Corruption in the banking sector has manifested itself in many scandals involving money laundering, rate rigging and tax evasion, all of which undermine the public's trust in financial institutions. Since the global financial crisis of 2008/2009, a number of high-level reforms have been undertaken, both at the regulatory level and at an operational level within banking institutions.

Among the key anti-corruption tools to consider within the banking sector are: having strong anti-bribery rules, robust anti-money laundering rules, managing risks associated with politically exposed persons as banking clients and tools to counter banking secrecy. To effectively counter corruption and promote integrity, these rule-based approaches should be complemented with measures to engender a culture of integrity in banks and financial institutions. These can include codes of conduct, public oaths, building incentives for integrity in remuneration packages and careful management of conflicts of interest. These measures should be accompanied by strong oversight and measures to ensure there is no impunity for wrongful behaviour.

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1 CORRUPTION RISKS IN THE BANKING SECTOR

Banks have a significant impact on the safety and soundness of the world's financial system, and the overall economic health of countries. The fallout from the global financial crisis of recent years, and of the bank bailouts and government austerity programmes that ensued, has brought this impact into stark relief.

Corruption in the banking sector has manifested itself in many scandals involving money laundering, rate rigging and tax evasion, all of which undermine the public's trust in financial institutions (Transparency International 2015). It has been noted that risk taking is intrinsically involved in the business of banking and that this can lead to unethical conduct at the expense of the public interest (Dewatripont and Freixas 2012). Indeed it is well established that excessive risk taking played an important role in the most recent financial crisis (Bebchuk and Spamann 2009; Dewatripont and Freixas 2012). Whether this was the result of skewed incentives built into remuneration schemes, shareholders' appetite for risk, a general culture of risk or the financial market's "short termism" or a combination of these factors remains an unresolved question (Dewatripont and Freixas 2012).

The financial crisis triggered many reform efforts. A 2013 KPMG report noted that for banks, "the single most pervasive driver of change is the regulatory agenda" (KPMG 2013). In the US, the Volcker Rule, a key provision of the 2010 Dodd-Frank Act, prohibits banks from conducting certain investment activities, and limits their ownership of and relationship with hedge funds (Fortune 2015). This structural separation is meant to encourage banks to take different approaches to retail and investment banking. The Basel III standards, agreed in 2011, are designed to ensure banks have enough liquidity to handle a potential run on funds, although, like many reforms, have been subject to intense lobbying by banks and have been delayed in their implementation (New York Times 2013). In Europe, the Libor rate-fixing scandal led to the amendment of the Market Abuse Regulation to impose minimum fines for insider trading and criminal sanctions for manipulating benchmarks such as LIBOR. Another area of increasing focus is anti-money laundering rules and "know your customer" regulations (KPMG 2013).

Alongside such financial reforms, many argue that attention must be paid to non-financial risks, including those posed by a bank's conduct. Addressing such risks requires nurturing a healthy culture of integrity within institutions, incentivising ethical behaviour and ensuring those involved in misconduct are held accountable for it (Transparency International 2015). It is widely recognised that any attempt to address the risks of corruption in the banking sector must involve a joint effort by the banking industry, regulators and supervisory bodies (G30 2015).

It is important to note that successfully countering the risks of corruption in the banking sector rely on certain fundamentals to be in place: respect for the rule of law, a strong and independent judicial system, and protection for whistleblowers who report corrupt or unethical practices within public and private institutions. Furthermore, in all contexts, a centrepiece of financial integrity is an independent, sufficiently resourced regulator.

It is also worth noting that most of the literature on anti-corruption mechanisms for the banking sector focusses on developed economies, although many of the lessons are likely to be transferable to banks in developing countries if the above fundamental conditions are met.

This paper draws mainly on the literature on financial integrity in developed economies. It is important to note that in developing countries, a major corruption risk is the abuse of banks to bankroll political party corruption through cronyism and the issuing of substandard "loans" among other devices. Countering this type of corruption requires in the first instance good internal audit functions, strong internal governance in the form of competent boards, independent rating agencies and well-resourced and independent regulators that can blow the whistle on such forms of corruption.

The rest of this paper outlines some anti-corruption mechanisms which fall under the legal and regulatory umbrella and following that, summarises some of the internal mechanisms which banks can adopt to address corruption risks from within and promote ethical conduct among employees.

2 REGULATORY AND NON-REGULATORY TOOLS TO COUNTER CORRUPTION AND PROMOTE INTEGRITY

Legal and regulatory mechanisms

Anti-bribery and anti-money laundering rules

Bribery and money laundering are two of the key types of corruption to which banks are exposed.

Among the general factors that place financial institutions at risk of being involved in bribery are: operating in corrupt environments, interacting with public officials, providing services to high-risk sectors (defence, construction) and the use of agents, counter-parties, relying on subsidiaries, or entering into joint ventures (Transparency International UK 2010: 20-21). Given these risks, the most fundamental tenet of an anti-corruption framework for the banking sector is a sound anti-bribery programme. The UK is often cited as having the strongest anti-bribery legislation in the Bribery Act (2010) as it criminalises the actions of bribing, receiving a bribe, bribing a foreign public official and, uniquely, failing to prevent bribery (TI-UK 2010: 41). Transparency International's Business Principles for Countering Bribery provide a framework for companies to develop comprehensive anti-bribery programmes (Transparency International 2013).

Effective anti-money laundering (AML) mechanisms are essential to prevent and detect corruption, both in the financial sector and in non-financial sectors such as real estate and casinos. A bank's client base presents serious risks. Through its clients, a bank might become complicit in laundering the proceeds of crime, including corruption (Transparency International 2015).

The global standards for anti-money laundering are the Financial Action Task Force (FATF) recommendations. These recommendations were first introduced by the OECD in 1990. Since then over 180 countries have committed to apply them (FATF 2012). The FATF recommendations note in particular the risk to financial institutions posed by politically exposed persons (PEPs) and state that financial institutions should be required to take reasonable measures to determine whether a customer or beneficial owner is a domestic PEP or a person who is or has been entrusted with a prominent function by an international organisation. In cases of a higher risk business relationship with such persons, financial institutions should be required to: obtain senior management approval for establishing or continuing such business relationships; take reasonable measures to establish the source of wealth and source of funds; and conduct enhanced ongoing monitoring of the business relationship. The requirements for all types of PEP should also apply to family members and close associates of PEPs (FATF 2012).

While the global trend is towards regulation of this risk area, implementation has been lacking. Neither OECD nor developing country AML regulations have proven sufficient to prevent the laundering of proceeds of corruption and crime, and compliance levels remain low. A World Bank report in 2010 found that only two per cent out of 124 assessed jurisdictions were fully compliant with existing standards on PEPs (World Bank 2010). Likewise in December 2013 an OECD report found low to very low compliance with international AML recommendations by the 34 OECD countries (OECD 2014).

It is worth noting that since February 2015, Afghanistan has taken steps towards improving its AML and countering financing terrorism (CFT) legislative framework, including by issuing an amendment to the AML Law to extend the money laundering offence to cover foreign predicate offences. However, the FATF has determined that certain strategic AML/CFT deficiencies remain. It has urged Afghanistan to continue to work on implementing its AML/CFT action plan, including by: (1) further implementing its legal framework for identifying, tracing and freezing terrorist assets; (2) implementing an adequate AML/CFT supervisory and oversight programme for all financial sectors; and (3) establishing and implementing effective controls for cross-border cash transactions (FATF 2015).

Beneficial ownership transparency

Hidden company ownership is a conduit through which much corrupt money is laundered and banks are particularly exposed to this risk. FATF recommendations 24 and 25 deal with company ownership transparency and measures that banks should take in this area. The core concept behind

"beneficial ownership" or "incorporation transparency" is the idea that one should be able to determine the real people who ultimately own, control or benefit from the operations of a company. FATF (2014) has argued that knowing the beneficial ownership of companies is particularly important for the banking sector so that they can better judge whether their corporate client is a money laundering risk, and it is important for law enforcement so that they can more easily follow the money in money laundering cases. They require banks to carry out due diligence to establish the beneficial owners behind company accounts.

In some jurisdictions, transparency in this area is being legislated for. In the UK, the Small Business, Enterprise and Employment Bill (2015), which establishes a public register of beneficial ownership for companies registered in the UK, received royal assent on 26 March 2015. Norway has followed suit, adopting a public register in June 2015 (Global Financial Integrity 2015). Other countries like Ukraine, Denmark, Austria, and France have also signalled their support for public registers (Financial Transparency Coalition 2015).

Internal mechanisms to promote integrity in banks

Experts from academia, civil society and the banking sector itself, agree that while regulation is essential to banking reform, it alone cannot restore banking integrity (Whyte 2010; G30 2015; Transparency International 2015). A recent G30 report stressed the need for a cultural transformation in banks, led by boards and management, designed to improve values and promote a culture of integrity. This, coupled with supervisory monitoring and strong accountability mechanisms, could help restore trust in banks (G30 2015).

Creating a culture of integrity

The importance of leadership when it comes to banking integrity is increasingly emphasised (G30 2015). A number of industry-led initiatives have sought to emphasise bank employee and management's commitment to integrity by instituting a form of public oath. A public oath can be an effective instrument to send a clear message to employees on what type of behaviour is expected from them (BFO 2011). In the Netherlands, bank employees must swear an oath promising they will perform their duties with integrity and that they will "endeavour to maintain confidence in the financial sector." This is part of an effort by the Dutch Banking Association and the Dutch government to restore trust in the sector which is at an all-time low. This follows the government spending more than 95 billion euros of tax payer money in capital and guarantees over the past six years to bail banks out following various allegations of mismanagement and wrongdoings (Transparency International 2015).

It has been noted that to be effective, such oaths should be accompanied by detailed codes of conduct which offer clear guidance on ethical dilemmas to employees (Transparency International 2015). The financial crisis raised scepticism about the usefulness of such "soft" tools as oaths and codes of conduct, given that most large financial institutions involved in the crisis indeed had codes of conduct and ethical guidance in place (McMillan 2012). As an example, McMillan (2012) points to Enron's 64-page code of ethics booklet. Webley and Werner (2008: 405) suggest that successfully embedded corporate ethical values requires "well-designed ethics policies, sustained ethical leadership and incorporation of ethics in organisational processes and strategy as part of an ethical culture at all levels of the organisation".

Remuneration

It has been posited that skewed incentives contributed to the excessive risk taking associated with the global financial crisis (Dewatripont and Freixas 2012). Given that a large amount of bankers' total compensation is determined by variable payments, such as cash bonuses, stock options, pensions and other benefits, which often exceed the base salary, there are clear opportunities to incentivise staff towards particular types of behaviour (Transparency International 2015).

Among the ideas put forward to incentivise integrity are to establish non-financial performance criteria for all employees (up to senior management) that are equally important to financial performance criteria when determining performance-related pay. This shift will help to place a premium on one's integrity, behaviour, and compliance with a company's anti-bribery and corruption programme (Transparency International 2015).

A further idea is to make full use of "clawback" and "malus" options. Clawback and malus arrangements in senior executive remuneration are tools to increase individual accountability for wrongdoings. They allow banks to recover part or all of performance-based bonuses in cases where there have been grave failures attributed to the executive's actions (or inactions). To account for possible long-term negative consequences, clawback clauses may be invoked even several years after the bonuses have been paid. Malus clauses only allow banks to withhold bonuses that have not yet been paid. Clawbacks were first robustly applied by banks in reaction to the foreign exchange rate market rigging scandal (Transparency International 2015).

Public disclosure of remuneration metrics is required in some jurisdictions (for US, see Dodd-Frank Act), opening decisions on remuneration to shareholder and public scrutiny and thereby increasing their usefulness as incentives for ethical conduct (Right2info.org). The Global Reporting Initiative (GRI) has called for the transparency of remuneration policies of financial institutions as well as stakeholder involvement in determining them.

Managing conflicts of interest

In the banking sector, insider trading is the most common conflict of interest. Insider trading refers to situations in which corporate "insiders" (executives, directors, and so on) buy or sell their company's stock on the basis of significant corporate information that is not available to the investing public more generally. (McDonald 2011). To address this risk, investment banks are required to separate their investment banking and brokerage operations by erecting information barriers or so-called "Chinese walls" (Transparency International 2015). The previously mentioned Volcker Rule has partially reinstated the separation between the investment and commercial sides of a bank's business in the US.

Conflicts of interest can also occur if public officials and civil servants move to lucrative private sector positions where they could use their government experience and connections to unfairly benefit their new employer. They may also move the other way, taking government jobs that help to benefit their previous employer. Cooling off periods are used to mitigate the risks of a conflict of interest leading to unethical and unfair decision making (Transparency International 2015).

Effective monitoring and accountability

In order to build a culture of integrity within an institution, there must be accountability for wrongdoing. The most effective deterrent for wrongful behaviour would most likely be prosecution of individuals up to senior management. However, the trend in the banking sector is for wrongdoings to be punished through settlements resulting in large corporate fines, the cost of which is borne by shareholders with little accountability for individuals (Transparency International 2015). There are moves to change this and increase individual accountability for wrongdoing. In the UK, for example, the Senior Management Compliance regime (due to enter into force in 2016) will require banks to regularly vet senior managers for their propriety and improve responsibility lines at the top, enhancing the regulator's ability to hold senior individuals to account (FCA 2015).

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