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Fraudsters at the Gate: How Corporate Leaders Confront and Defeat Institutional Fraud—Part 1

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Alex D. Moglia

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☞ Bankers' duties; Board of directors; Corporate governance; Ethics; Fraud; Money laundering; Risk management

Abstract

Serious fraud poses numerous challenges for corporate stakeholders and victims beyond economic, reputational and other obvious losses. In this two-part article, a companion to their work "Multi-jurisdictional Concealed Asset Recovery: Managing the Risks" published in Issue 1 of J.I.B.L.R. in 2015,¹ the authors elaborate the key issues, duties and responsibilities senior corporate leaders must confront when their institution has been defrauded. Additional areas covered include the impact of compliance on an organisation, management of fraud and money laundering risks, and model-building an effective anti-money laundering (AML) plan based on ethics and regulatory compliance. The second part, to be published in a future issue, will address tools, danger signs, reactions to fraud—including institutional leaders' instincts for self-preservation over their organisation's best interests—and the common pitfalls of racing to the scene of the apparent fraud. The authors will also discuss the challenges created when large-scale frauds create a negative collateral public impact by causing harm to additional classes of victims besides investors, employees, or vendors, and damaging the social and economic fabric of society. The second part will conclude by delineating

recommendations for senior management to pursue the greater good, rather than hiding behind corporate aprons to avoid what is often perceived as the greater bad.

Introduction

With the benefit of hindsight we now all know that weak oversight and a lack of transparency contributed to the financial crisis. But almost ten years on, has much changed? How much has been meaningfully done to address the recognised and acknowledged deficiencies of the banking system? While there has been a great deal of talk about instituting important reforms, many bank leaders may simply be paying lip service and carrying on as if all is well and normal.

Transparency International (TI) highlighted the importance of testing the integrity of banks and bankers in an October 2014 article titled "Banks need integrity, not just stress tests".² Integrity lapses have continued in the banking sector well after the fall of Lehman Brothers in 2008. Although banks have been fined for regulatory lapses since then, such deterrents appear to have had only a modest impact; indicators of improvements to attitude, policy, or compliance are few and far between.

Numerous banks have policies on anti-corruption and AML but their track record on enforcing them is poor. Banks and banking rely on trust. Trust can take years, if not decades, to establish, but can be lost in an instant. The banking sector has yet to recover from the loss of faith triggered by the financial crisis, and with a stream of new instances of gross misconduct continually being brought to light, rebuilding trust is all the more difficult. TI suggests that we need a way to assess both the leadership culture of banks and the actions taken to win trust back. These should be integral to stress tests and general regulatory duties.

It is important to recall that the banking crisis, which ultimately led to the brink of a worldwide economic cataclysm, was not just the result of a few rogue traders placing irresponsible bets. It was the byproduct of the serial, wanton pursuit of profits, bonuses and growth—craven greed in its purest form—that infected the entire global financial system.

The banking sector plays a crucial role in the global economy as intermediators of funds. Funds can then be made available to support enterprise and innovation and help drive economic growth. Banks' safety and soundness are key to financial stability, and the manner in which they conduct their business is, therefore, central to economic health. Governance weaknesses at banks, especially but not exclusively, those which play a significant role in the financial system, can result in the transmission of problems across the banking sector and

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¹ Martin S. Kenney, Alex D. Moglia and Alexander Stein "Multi-jurisdictional Concealed Asset Recovery: Managing the Risks" (2015) 30 J.I.B.L.R. 1–12.

² TI, "Banks need integrity, not just stress tests" (2014), available at: http://www.transparency.org/news/feature/banks_need_integrity_not_just_stress_tests [Accessed 10 October 2016].

into economies in outlying jurisdictions. Thus, effective and sensible corporate governance is critical to the proper functioning of the banking sector and the global economy.

Duties and responsibilities of leaders of financial institutions

Corporate governance

Corporate governance determines the allocation of authority and responsibilities by which the business and affairs of a bank are carried out by its board and senior management, including how they set the bank's strategy and objectives; select and oversee personnel; operate the bank's business on a day-to-day basis; protect the interests of depositors, meet shareholder obligations and take into account the interests of other recognised stakeholders. It is vital that bank leaders seek to align corporate culture, and corporate activities and behaviour with the expectation that the bank is operating with integrity, in a sound manner, and in compliance with all applicable laws and regulations.

A number of the world's largest banks are still failing to implement much needed cultural and conduct reforms in their businesses. The G30 (an international body of leading financiers and academics which aims to deepen understanding of economic and financial issues) notes that, while efforts have been made to strengthen internal cultures, many banks still need to implement reforms on compensation and the dismissal of employees, including top executives. A report issued by the G30 in 2015 entitled *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform* (the 2015 Report)³ states that failure by banks to implement across-the-board cultural and conduct reforms could lead to still more regulatory rules and actions. Jean-Claude Trichet, chairman of the G30 and former president of the European Central Bank, warns that "piecemeal approaches are not good enough and that aspirational leadership statements by bankers must be matched by effective and disciplined implementation programs".

The imperative for far-reaching changes in the ways supervisors and boards of directors of financial institutions work together to improve the safety and soundness of banks had been clearly signaled by the G30 in its 2013 report on banking supervision and corporate governance of global financial institutions (the 2013 Report).⁴ Introducing that report at a London press conference, Jean-Claude Trichet said:

"[E]xperience since the financial crisis shows that new banking rules and regulations are not sufficient. Improving governance requires careful nuanced judgment by banking supervisors, and more active leadership by boards of directors. Achievement of

effective supervisory outcomes will depend on the establishment of better relationships of mutual trust between supervisors and boards."

The 84-page 2015 Report on banking culture was compiled after conducting almost 80 interviews with industry leaders, central bankers and other officials in 17 jurisdictions. It highlights six areas where banks should be focusing their attention. As the 2015 Report states in its foreword: "banks and banking rely on trust ... while trust takes years to establish, it can be lost in a moment through failures caused by problematic ethics, values, and behaviors".

The 2015 Report recommends that most banks should aim for a fundamental mindset shift regarding institutional culture. The 2015 Report recognises the need for a shift in approach to problems affecting the economic sustainability of the banking institution. CEO and executive team leadership must grapple with difficult internal sanctioning decisions in a consistent manner, for example, by ensuring that material consequences flow from breaches in terms of both termination of implicated management and employees, and significant compensation adjustments. Sanctioning must affect not just lower level employees but also those with oversight responsibility, including the CEO, for any new issues that arise, and must include those who exercise willful blindness. The 2015 Report recommends, *inter alia*, that:

- banks should look at culture, and achieving consistent behaviour and conduct aligned with firm values, as key to strategic success, rather than a separate work stream or add-on process to respond to short-term public, regulatory, or enforcement priorities; and
- banks' behaviours and conduct should be open to constructive internal challenge. Banks need to have processes that welcome and can deal with self-identification or escalation of issues.

So how is this achieved? According to the 2015 Report, banks must work to fully embed the desired culture through ongoing monitoring and perseverance, drawn from four key areas:

- senior accountability and governance;
- performance management and incentives;
- staff development and promotion; and
- an effective triple-line of defence.

The oversight of embedding values, conduct, and behaviours must remain a sustained priority. The primary responsibility for this rests with the CEO and his or her executive team. Bank leaders must ensure that there is a thorough review process in place that measures the bank's brand and reputational standing and fosters liaison with

³ Available at: <http://group30.org/publications/detail/166> [Accessed 18 August 2016].

⁴ G30, *A New Paradigm: Financial Institution Boards and Supervisors* (2013), available at: http://group30.org/images/uploads/publications/G30_BankingConductandCulture.pdf [Accessed 10 October 2016].

internal and external stakeholders with a view to encouraging feedback to and proposals for any corrective or strengthening initiatives to the executive team.

Bank leaders must also foster a culture of responsible performance management. That is, a performance review process that rewards only individuals who meet a threshold of acceptable behaviour in alignment with firm values and conduct expectations. Such a review process may include bonus reduction or elimination, or even clawbacks in the event of failures to meet acceptable standards judged on objective criteria. The process of review must ensure that those responsible for misconduct and violation of bank culture suffer meaningful consequences, such as reduced compensation or, in worst case scenarios, employment termination. Disciplinary action must be followed through in each case of non-adherence, whether to corporate culture or internal regulation, and staff must be made acutely aware that such punitive responses are uniformly applied. Bank leaders must ensure that staff are regularly made aware of what is expected of them and what types of conduct will not be tolerated.⁵

This approach must be followed from the top down and bottom up. Not just lower level employees but all levels of management must share and adhere to values and cultural and behavioural expectations. While bank management bear the primary responsibility for fostering the desired culture, ethic and conduct, lower level employees must be encouraged to share that responsibility through a process that involves comprehensive training, value embedding, and respect. Thus, lower level management and floor level staff should be encouraged to own compliance and risk management functions, and take responsibility for their own sphere of influence rather than relying on management to police action and or inaction. Supervision involves not just box-ticking but analysing information and making judgements about the risks inherent in certain situations. Those bearing higher levels of responsibility and tasked with supervisory functions should be appropriately recognised and rewarded. Remuneration levels in such functions should attract high-quality individuals who would earn and command respect. The quality of management and governance systems must be scrutinised, and then dismantled and rebuilt where necessary. Bank leaders must come to realise that a dose of supervision is far more effective than a cure for the lack of it.

A change of mindset

It is clear that banks and financial-services firms must undergo a cultural mindset shift if they are to regain the trust they have lost over the past several years and if they are to remain viable in the future. The economic crash and the uncertainty that continues to dog financial markets

has resulted in a significant shift away from an unquestioning faith in the capitalist model of wealth management and distribution. That shift is reflected in the political changes that have taken place over the last decade, and in the political uncertainty playing out in many jurisdictions around the world. The goal of the finance industry should not only be to maximise shareholder wealth, but to underpin societal development by supporting economic activity and creating value and jobs. It has a broader responsibility to society which, it seems, has been all but forgotten in the pursuit of profit.

Banks are not alone in that and the backlash from society is not just confined to the banking sector. We all expect multinational firms to show responsibility towards the environment, their employees and, of course, consumers. But banks are in a particular category. They are bound by fiduciary duties and benefit from state implied guarantees. The financial industry wields immense power over societies, economies and people. For example, consider the implications of decisions to raise interest rates or the decision to suspend lending to new businesses. This type of power must be accompanied by accountability and responsibility—to customers, shareholders, and society at large. The highest ethical standards must be maintained.

Board oversight

Board oversight is a key component of the overall effort to improve the culture and accountability of the banking sector. The role of banks' boards of directors has expanded considerably in the past two decades. Following the financial crisis, risk oversight was pushed to the fore: so-called risk committees were introduced, along with expanded stress testing and more detailed and expansive risk reporting. For example, organisations that fall under the US Federal Reserve's enhanced prudential supervision mandate are required to establish a standalone risk committee that operates under a formal written charter approved by the company's board of directors. They include banks holding assets greater than US \$50 billion, publicly traded banks with greater than US \$10 billion in revenues, and any non-bank financial company designated as systemically important.

The board and, in particular, the risk committee, play major roles in overseeing the implementation of stronger risk governance approaches and risk-related regulation. Recent regulatory changes and other pressures are pushing boards to focus more on bank strategy and the structural and operational reform required to support expected future performance. The evolution in conduct and culture also places significant demands on boards—requiring substantive board engagement. Gone are the (good) old days when a seat on the board of directors of a bank was a ticket to ride the gravy train without having to heed the

⁵ Otherwise, bank leaders will be scrutinised and criticised (or worse) for the actions of their subordinates. Witness the Wells Fargo Bank incident which was revealed in September of 2016, where, according to media reports and testimony before the US Congress, more than 5,200 employees were terminated for apparently creating some two million fictitious and/or unauthorised customer accounts so as to boost the bank's revenues. This incident appears to illustrate how unethical and unlawful conduct can flourish in large commercial enterprises.

signals or put a hand to the machinery. Members of bank boards are increasingly, and rightly, being held to account for systemic failures.

Bank boards face particular challenges and responsibilities compared to other organisations. These primarily reflect the systemic risks associated with banking, and also specific regulatory requirements to mitigate conduct risk. In the UK, The Treasury Committee's Ninth Report entitled *Banking Crisis: reforming corporate governance and pay in the City*⁶ observed that much commentary on the banking crisis had overlooked or underplayed the primary responsibility that the boards of banks have for their own failures.

Regulatory compliance

There have been many reports issued in the aftermath of the financial crisis. The majority of them point out that radical reform is required to improve standards across the banking industry. Regulatory compliance is but one of the areas where reform is needed. Compliance departments should have specialist units with relevant expertise dedicated to each and every aspect of compliance. It should, however, be borne in mind that the term "regulatory compliance" is a catchall that encompasses compliance in a variety of areas ranging from accounting to corporate to environmental and even further afield. Evidence presented to the UK Treasury Commission, for example, suggested that the compliance function was often faced with a multiplicity of tasks, from approving new product launches, to providing a legal-style advisory role on regulatory issues, to providing assurance that the bank's systems and controls are working appropriately. Its final report, *Changing Banking for Good*,⁷ noted that risk and compliance functions were too often treated as cursory box-ticking exercises, to satisfy internal control or regulatory requirements, but which had limited practical impact on front-line activity. These problems are often exacerbated by the divide between the "police" and the "policed" within banks, where the highest status and rewards are afforded to those generating the most revenue for the bank.

The 2015 Report underlines the importance of banks having clear lines of accountability for the assurance of overall regulatory compliance and clearly recognises the risks inherent in absolving the front line from responsibility for risk. As pointed out above, there should be unequivocal limits or boundaries for compliance roles to avoid the potential for involvement in conflicting roles, for example, participation in product development and subsequent control in that particular sphere. The importance of compliance within the spirit, not just the letter, of regulation must be brought home to every individual in a bank. This responsibility cannot be outsourced. Furthermore, vigilance, not just compliance, is called for. Banks and their leaders must ensure that

staff have a clear understanding of the duty to report any instance of wrongdoing, or even the suspicion of wrongdoing, within the institution.

In the past, significant pressure was put on front-line staff to sell products. This was not just as a result of financial incentive structures, but also as a result of less formal influences such as the pressure to perform, to play with the team, drive profit and curry favour with superiors. In some cases, those products were far from ethical but staff felt obliged to maintain the status quo; few were willing to be the first to shout that the Emperor was naked! Banks need to implement mechanisms for staff to raise concerns in situations where they have ethical or prudential questions or issues regarding specific products or practices, even where there is no allegation of wrongdoing. Accountability for ensuring such mechanisms are in place, and that concerns are noted, logged and reviewed should rest with the ombudsman's office or the non-executive director responsible for whistleblowing.

Stakeholder engagement

The message to be taken home is that there is no cure-all. Structural or procedural changes to bank boards would not have prevented the last crisis and will not prevent the next one. However, certain changes must be made with a view to ensuring that the financial safety and soundness of the company is put ahead of the interests of its members. Previously, bank leaders and boards of directors were concerned first and foremost with their shareholders and the need to drive profit, often at all costs. The financial crisis has taught us that profit before people is not a viable model. Indeed, the pressure for profit led to the failure of many banks and a massive loss of investment for many shareholders. While bank leaders must always keep the interests of shareholders in mind, that interest can no longer be pursued to the detriment of other interests. That the financial safety and soundness of a bank be put ahead of the interests of its members now seems a common sense approach. The benefit of hindsight is a wonderful thing; it's difficult to imagine publicising such a proposal prior to 2007 and not having it derided into oblivion.

So, who are the stakeholders, actually? Stakeholders can include customers and depositors, regulators, investors, taxpayers, politicians and the directors and staff of banks. When we speak of stakeholders, we tend to think first of investors. Investors in banks, whether equity holders, debt holders, or funders, share a common interest, however, with other stakeholders, in the effective governance and management of the financial system. Stakeholders, including NGOs, investors, and activists, as well as communities, staff and consumers, are playing an increasingly important role in improving corporate behaviour in a broad range of industries; the banking

⁶ UK Treasury Committee, *Banking Crisis: reforming corporate governance and pay in the City* (2009) HC Paper No.519 (Ninth Report of Session 2008–09), Ev.252.

⁷ Parliamentary Commission on Banking Standards, *Changing Banking for Good* (June 2013), available at: <http://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/> [Accessed 11 October 2016].

industry is no exception. Capital-market participants increasingly expect banks to involve a range of stakeholders in their corporate social responsibility process, and they understand the significance of positive public image and, of course, the damage of negative publicity (the recent “Panama Papers” scandal being a resounding cautionary tale).

Stakeholder engagement is a crucial aspect of improving trust in the banking sector, and recognition of the interests involved is a key step in any strategy to improve performance and repair reputational damage. Stakeholder engagement must, however, be coupled with transparency in decision making, both internally and externally. Seeking out and encouraging the greatest stakeholder engagement possible increases credibility, and is also becoming a required component of sensible business strategy. Bank leaders have a vital role to play in driving stakeholder engagement and fostering inclusion, and successfully balancing all interests can best be achieved where the process of decision making is clear and the decisions made objectively rational. There can be no more “behind closed doors”, “old boys’ club”, “funny handshake” decision-making process and bank leaders must face this reality or become relics of a not so ancient past. In the words of Andrew Large, author of Occasional Paper 92, “Financial Stability Governance Today: A Job Half Done—Ongoing Questions for Policymakers”⁸:

“[T]he financial industry (not just the banks) needs to acknowledge that behaviours need to change—that contrition is called for, and the only way forward is to stop lobbying and special pleading, and to become part of the solution rather than the problem.”

The impact of compliance on an organisation

Culture

There can be no meaningful discussion of compliance, beyond mapping its general functional intent as a policing unit, unless and until an institution has first defined its culture and delineated its understanding and expectations regarding integrity and ethics. Without a sound cultural infrastructure constituted of thoughtfully considered institutional values and ethical practices, compliance is only an abstraction.

We have spoken above about the cultural and conduct reforms required within the banking sector. To begin, we must clarify what culture is and also what we mean by ethics. There is near universal agreement that every organisation has a culture, that it crucially influences human behaviour, and consequently impacts virtually every aspect of an organisation’s performance, profitability and reputation. Yet there is little consensus about how that happens. Does culture have a definable

function and, if so, what is it? To what degree is culture-building controllable? In what ways is culture flexible or malleable? How can it be customised? What are the potential inherent assets and liabilities of focusing on culture-building or, conversely, neglecting or peripheralising it?

Many organisations respond to such questions with chicken-or-egg origin stories: the organisation’s leadership team deliberately authored and constructed the culture; or culture arose or evolved over time more or less of its own accord. The first position often suggests a conservative corporate command and control management philosophy which favours militaristic legislation of performance, attitude and behaviour standards mediated through incentives and punishments. The second considers culture a soft intangible, an unquantifiable gaseous byproduct formed by the implementation of solid administrative and operational systems, structures and protocols.

Organisational culture is at its core a system of shared assumptions, values and beliefs which governs how people behave and treat one another within that organisation. These shared values strongly influence all aspects of life and experience in the organisation and dictate expected standards of dress, behaviour and professional performance. Every organisation develops and maintains a unique culture.

The unifying principles and codicils governing culture will necessarily vary from one institution to another, largely depending upon its primary business and the sectors and jurisdictions in which it operates. Our dominant focus here is financial institutions. These typically require air-tight compliance with an array of local and federal AML and other relevant laws, regulations and guidelines. As such, the paramount priority for every facet and characteristic of culture-building in most financial institutions is, above all else, to promote, privilege, certify and cross-check the highest degrees of ethics, integrity and procedural correctness.

If the core value is integrity, culture-building should also include such other interlacing elements and characteristics as:

- **vision:**
a statement articulating an organisation’s ideal purpose for conducting its preferred business;
- **values:**
tenets and principles concerning behaviours and mindsets needed to serve the corporate mission with professionalism and fairness;

⁸ Available at: <http://group30.org/images/uploads/publications/op92b.pdf> [Accessed 18 August 2016].

- **practices:**
delineation of guidelines for creating and executing practices which promote and facilitate not only an organisation's needs regarding execution of various business lines but, more importantly, its central values, ethos and stringent compliance-centric performance requirements;
- **people:**
principles governing stringent recruiting, hiring and contracting out, as well as partner, affiliate or third-party vendor engagement policies ensuring that all people and organisations with whom an institution transacts or conducts business align with the core values or possess the willingness and ability to embrace and uphold those values;
- **narrative:**
a key element of culture creation is crafting and communicating an organisation's unique history and story. Thoughtfully shaped narrative threads are powerful ingredients in creating and defining culture; synthesising core values and ethics then become potent embedded features of organisational identity; and
- **place:**
geography, architecture and aesthetic design impact the values and behaviours of people in a workplace. The layout and furnishings of an office can promote or inhibit certain behaviours, such as collaboration or communication. Certain cities or neighborhoods have local cultures that can reinforce or contradict the culture a company is trying to create. Any place in which employees work has actual physical importance.
- **prioritisation of ethics over productivity:**
many financial institutions are purely profit driven and focus on results and return, but not on how these are achieved. As noted above, a culture of profit-at-all-costs was a significant contributing factor to the economic freefall of late 2007–early 2008. While anathema to many money managers, emphasising maintenance of compliance requirements and commitment to values-driven transactions over by-any-means-necessary outcome metrics will more likely reduce the probability of both negligent and malicious insider events;
- **emphasis on people and fairness:**
the importance of treating employees and partners with respect and dignity cannot be overstated. Placing a high value on making decisions which are fair, sensible and ethical are critical to ethical and compliant institutional culture; and
- **teamwork, collaboration and communication:**
hierarchical segmentation, vertical detachment and balkanised systems tend to create disaffected and disenfranchised individuals who become exponentially more susceptible to corruption and are more likely to perpetrate, enable, or participate in malfeasant or unethical acts. Proven counter-agents include placing a high value on organising a work culture which is conducive to collaboration, interaction and communication, and which fosters positive collegial relationships between and among coworkers and managers.

There are also additional clusters of institutional characteristics which, when properly oriented, customised and calibrated in furtherance of core values, can fortify compliance and reduce malfeasance risk. These include:

- **precision and attention to detail:**
placing a high value on attention to detail, and expecting employees to perform their work with precision, accuracy, thoroughness and care;

These are but a sampling of institutional characteristics that contribute to a culture of responsibility and respect within the banking community. However, those institutional characteristics must be firmly underpinned by a strong, shared work ethic within the institution coupled with a well-defined corporate ethic that is fostered from the bottom up and practiced from the top down.

Ethics

Ethics is traditionally understood to involve how people behave in dilemmas and circumstances entailing right and wrong. A well-established axiom asserts that values drive behaviour. Values influence attitudes and are integral to the formation of both individual and systemic response systems in organisations. Therefore, a clearly defined culture of values and ethical behaviour is a critical ingredient even where the organisation is populated by

ethics, who would profess to know the difference between right and wrong, and could foresee which choice to make when facing an ethical dilemma on their own.

The definition of ethics we advance here is the judgement to exercise restraint irrespective of one's capacity to act. An ethical transgression—distinguishable from an ethics violation—can be understood as an individual (or entity) acting in self-interest and with disregard, indifference or outright malice to broader adverse ramifications.

To this end, institutions should compose and issue an Ethics and Values Statement (or howsoever styled) which maps the terrain of institutional values, philosophies, standards and expectations regarding ethical conduct across a broad spectrum of situations and relevant practice or transaction areas. Companies should also make the details of ethical practices and services, including guidelines for steering virtuous values into ethical conduct, readily available to all employees and others with whom business is conducted.

There are two primary recommended mechanisms deployed in tandem to rigorously promote and implement ethical conduct. One focuses on the people—inside-oriented—and the other involves the various offices, officers, policies, programs and systems built into an organisation—outside-oriented—through which a company can monitor, regulate and address ethical issues as they may arise.

The attributes and characteristics of inside-oriented ethical attitudes and behaviour may fluctuate from one organisation to another depending on a host of variable elements, but, in brief, the fundamental methods for designing and implementing an ethical organisational culture involve all of the following:

- hiring practices;
- institutional values;
- communication;
- leadership and management tone and style;
- integration of compliance-driven imperatives into core organisational culture;
- implementation of whistleblower best-practices, including encouragement to report wrongdoings, non-retaliation and non-discrimination provisions, confidentiality and a defined, secure reporting process;
- creation of an ethics forecasting system with incident management policies, including justice, education, confrontation, warnings and consequences; and
- design and deployment of psychodynamically sophisticated tools for managing conflict and other ethics or values-related disturbances, including implementing programs and procedures (such as an Ombudsperson or equivalent in close collaboration with designated liaisons of the internal fraud risk office, Chief

Information Security Office, compliance office or similar) for reporting and response which fosters forthrightness and action while minimising mishandling or avoidance.

Towards a compliance culture

A compliance manual can never be more than an inert articulation of aspirational precepts and guidelines for organisational ethics and adherence (or non-violation) with institutional, statutory and regulatory mandates. An institution cannot become operationally compliant or embody a culture of ethics-in-action only because a comprehensive and intelligent document has been prepared and disseminated.

A compliant institution requires stewarding fully harmonised integration of values, ethics and culture into all arms, branches and sections wherever situate. But most particularly, as we have discussed elsewhere, sensible, ethical and accountable governance—in the senior management team and on the board—is uppermost in determining and ensuring that risk and compliance guidelines will be followed. A culture of compliance, while mandatory and important, is easy to profess. A culture of ethics, though requiring substantial effort and attention to build and sustain, is its own robust mitigation system.

With all of this having been offered regarding culture and ethics, we turn now to the questions, how do we go about managing fraud and money laundering risks on a practical level? Of what variables do we need to be aware?

Management of fraud and money laundering risks

The proper management of risk is predicated on the accurate identification and understanding of the risk's properties and potentials. In the universe of all risk classes, human risk—the complex intangibles and drivers underpinning peoples' behaviour and decision making—is by orders of magnitude the most unstable and unpredictable.

Especially as it relates to human risk—as distinct from transactional risks—the divergences between theory and reality with regard to cultural integrity, ethical practices, bullet-proof compliance programs and high-octane risk mitigation protocols are analogous to the idea of water versus the experience of drinking or swimming. There may be an intersecting dataset, but one is dry and the other is wet.

Compliance, AML and white-collar malfeasance monitoring, assessment and remediation instruments must be capable of scanning for, analysing and responding in real-time to an assortment of complicated human factor elements beyond basic items such as intelligent hiring, integrity audits and suspicious activity investigations. One of the most important includes understanding the

reasons why good people sometimes do bad things. There are numerous ingredients and explanations, including rationalisation, justification, incrementalism, greed and personal circumstances. There are also a number of less easily explained psychological forces which can lie dormant until triggered by distinct situational or environmental ingredients. Conventional psychological and Emotional Intelligence tests frequently miss many important predictors.

Another element of human behaviour often overlooked is the value attached to blind loyalty or unquestioning obedient adherence over acceptance of a common ethical paradigm. The appearance of compliant behaviour within an organisation may provide false confidence regarding the effectiveness of compliance controls. Not infrequently, this quiet before a storm is mistaken as quiet stability. Genuine institutional stability and compliance is directly linked to an organisation populated by people sharing common values, and committed to upholding a common ethical paradigm.

The human element is too often overlooked in compliance and risk management, and particularly so within financial institutions. Bank leaders must recognise and understand that there are powerful psychodynamic forces at play where people are concerned. People are not machines and the impact of irrationality, fallibility and unpredictability cannot be underestimated. Such attributes are generated by complex states of mind and distorted or amplified in social and other contexts. Personalities, however well-intentioned, can undermine the best internal control systems. An effective system of internal controls is almost fully reliant on the abilities and foibles of those who administer it and those who must comply with it. Hence, it is critical that the human element be factored into this equation by senior leadership, compliance and all other risk management areas.

Model building—effective anti-fraud/money laundering planning

Traditionally, banks and other financial institutions have seen regulatory compliance as a necessary evil that ties up personnel in banal tasks such as filling out forms and reports, or which prevents members of boards of directors and officers from getting on with the real purpose of free enterprise—earning profits. We have spoken about how banks need to foster a culture of compliance and how that requires a deep cultural mindset shift and an in-depth appreciation of the human elements at play. But how do we, practically speaking, embark upon developing a model that takes such diverse elements into account?

First, large, traditional institutions, including banks, must realise that responsibility for observing good compliance practices is not the burden for any single institutional office, but rather, is shared throughout management. The new thinking is that such burden must be non-delegable; and indeed it appears that business and regulatory practice is heading more in that direction. Decision-makers at financial and other related institutions

who are generally oblivious to anti-fraud and money laundering laws such as the US Foreign Corrupt Practices Act 1977 (FCPA) or the UK's Bribery Act 2010 and other similar laws, erode the efficacy of compliance officers and create weak spots where corruption can take root. A culture of derogation of responsibility and inculcation of fear has not prevented corruption in the past and will not do so in the future. When designing fraud prevention and investigation plans, banks need to encourage employees to do the right thing, even if they cannot stop others from doing the wrong thing. While fear of detection can productively serve as a deterrent factor in compliance and fraud prevention plans, incentivising workers to avoid punishment for misdeeds is ultimately less effective than encouraging them to think ethically and legally and to act accordingly.

Fraud prevention planning

Assuming all the planets are aligned for a bank to be a good citizen of the world, what should those banks do to encourage their employees, customers, vendors and investors to act ethically and legally?

One effective and time-tested approach is to ensure that the design and implementation of regulatory plans are the joint responsibility of legal and financial officers. Conferring top officers with the responsibility for both designing and implementing fraud prevention and mitigation plans gives those officers and their reports, a vested interest in promoting compliance. There should be an institutional realisation that if something goes really wrong, it will affect everyone. Ultimately, mitigating financial losses, elimination of jobs, departments and product or service lines, payment of civil penalties and criminal sanctions are shared responsibilities with shared consequences.

Some larger banks have created “fraud police”—in-house units established to identify, investigate and prosecute wrongdoers. Frequently, these units are staffed with ex-law enforcement and private security personnel, as well as financial professionals, who are required to immediately internally disclose their findings to facilitate a rapid incident response—determining appropriate actions regarding an array of business areas, shareholder reporting and reputation management. However, internal policing is but one element in fraud prevention planning.

An effective fraud prevention and mitigation plan should incorporate a variety of factors and achieve certain distinct ends. It should, *inter alia*:

- present a clear set of objectives;
- identify a clear fraud prevention and mitigation strategy;
- develop written policies and procedures;
- involve specialised personnel who report directly to, and are supported by, top management;
- develop investigative priorities that are in concert with compliance objectives;

- foster a quick response mentality—especially important when a bank is the target of a cyber-attack, which requires immediate targeted counter-measures to limit damage, prevent recurrence, rebuild customer, vendor and shareholder trust and preserve value;
- promote access to and use of forensic tools (whether internal or external);
- provide effective case management administration support; and
- quantify damages and resolutions.

The overarching goal must be to think preventively and act pre-emptively when identifying and mitigating fraud. Enhanced awareness must permeate all sectors of an institution. This awareness is not confined to combating fraud and corruption but also in detecting other types of violations, such as cyber-attacks.

The best policies and procedures in the world are only as effective as those tasked with implementing them. Even well-designed anti-corruption plans will fail if the integrity and competence of top management and investigation units are, for instance, ignorant of diverse cultural customs and multijurisdictional variations in law governing the network of countries in which they operate.

Other aspects that are often overlooked include the ability to translate and adapt global policies and procedures for use in the different jurisdiction in which an institution has branch offices. International banks have branches and offices in many locations throughout a number of jurisdictions which operate under widely varied and, not infrequently, conflicting legal systems. When a bank deals with multiple locations in multiple countries and conducts business with customers in those and other countries, it must be alert to the risk of mistaking acceptable standard business practices with disguised corrupt practices.

Risk mitigation planning in such contexts necessitates accounting for local customs, practices and even confounding cultural idiosyncrasies which must be acknowledged and respected. Employing multilingual team members is vital to conducting business multinationally, but is itself a risk factor: there have been cases where interpreters and translators engaged to assist internal fraud management and investigation teams were hidden insiders abetting fraudsters or other bad actors. In less malignant scenarios, translators who are not sufficiently versed in compliance jargon and practice will be unable to effectively convey the meaning, intent or consequence of particular proposed policies or procedures. As a consequence, crucial components of a plan or policy may literally and figuratively get lost in translation. But, at the other end of the spectrum, locally based financial professionals engaged by global institutions often bring uniquely relevant insight and expertise regarding differences in the structure and design of financial

processes, policies and controls in various international locations. That is indispensable to an institution's ability to prevent and detect fraud risks.

Many large banks and other companies invest significant resources in technology and statistical evaluation techniques to couple disparate data sets with specific inquiries configured to detect abnormal hits or other anomalies signalling possible fraud or other malfeasance red flags. These tools are readily adjustable and reprogrammable, requiring simple updates based on current situation assessments or shifts to anticipated threat variables.

Algorithmic and other technological threat or attack protection layering is a complex and rapidly expanding domain. A full discussion is beyond our scope here. Suffice it to say that present technology-based detection/protection tools hold the potential, contradictorily, to both reduce and amplify malfeasance risks. Despite the appeal of proclaimed bullet-proof compliance programs and airtight anti-fraud systems, the reality is there is no single plan, technique or protocol which can by itself prevent or inoculate against the misguided creativity, passivity or any of a host of other human factor components that breed unaccountability and give rise to wrongdoing.

While many technological processes can enhance co-operation with ethical conduct codes and facilitate co-operation with compliance norms, there are numerous pathways to undermine or defeat them. Well-established examples include reporting false results or deliberately omitting critical procedures that are later explained as "oversights" rather than intentional violations.

Traditionally, legal and compliance departments would take a lead position in investigating or resolving potential malfeasance. However, again, the issues involved in reporting or pre-empting wrongdoing are vastly more challenging in reality than in theory. Senior supervisors are not always sufficiently trained, prepared or supported to be able to properly assess the veracity of information to which they become privy. And not infrequently, and despite established protocols, supervisors make ultimate decisions regarding reporting, escalation or suppression of potential red flag issues alone rather than within secure, preset pathways involving additional consultation and data analysis.

Financial institutions are increasingly recognising the importance of establishing whistleblower policies as integral to their compliance and malfeasance risk platforms. In addition to establishing and maintaining an internal culture of honesty, integrity and accountability, institutional leaders must understand the importance of treating employees respectfully, including creating secure avenues by which critical information they might possess and be able to surface will be treated and responded to appropriately. There are substantial consequent risks to ignoring or minimising whistleblower or other reporting policies, including engendering hostility or retaliation from employees who feel their concerns and efforts to report are not taken seriously. They may be more inclined

to externally disclose any violation or other sensitive information to the press, government authorities or competitors.

Managing internal investigations

Banks must tread carefully when handling possible breaches or discovery of possible wrongdoing. A traditional, pejorative view of legal and compliance departments is as “complicators” or “pests”. It is the duty of leaders of banks to proactively dispel such prejudices and to regularly and persuasively advocate ethical and legal behaviour. They must involve themselves in monitoring and managing investigations. In this way, legal and compliance departments can become destigmatised as an “extra” and can be properly integrated as an essential part of the overall institutional counter-malfeasance initiative.

Employees should not see wrongdoing tacitly overlooked or forgiven, just as internal reporting or whistleblowing cannot disappear into a black hole of inactivity. Particularly given the increasing oversight by national governments, and the proliferation of both new and amended fraud prevention laws, effective compliance and anti-fraud efforts must involve both in-house counsel and outside or “independent” law firms. However, as we are emphasising, fraud prevention and mitigation is neither a wholly legal, compliance or financial effort. It is a collaborative, multidisciplinary enterprise and senior corporate officials must practice what they preach. Anti-fraud programs in organisations where this is not the case will otherwise only be decorative.

Fraud and malfeasance defence is predicated on institution-wide awareness and knowledgeable participation in detection and mitigation policies and procedures. Every executive and division head—from the C-suite to the accounts payable clerks and all in between—must be fully versed in their functional areas of responsibility regarding anti-fraud monitoring.

But, of course, all best efforts cannot prevent incidents from occurring. Discovery of an ongoing or recently completed malicious insider attack or fraud event is a decisive and traumatic turning point for any institution, whether it had been prepared and defended and is now dismayed to have fallen prey nonetheless or simply had hoped it would never happen. The processes engaged post-detection will vary from organisation to organisation and from situation to situation. But there are, irrespective of institutional and situational particulars, certain core investigative tasks and procedures to follow. One is that those tasked with investigating should target the brains or leaders of the illicit activity. This is usually done through interviews of all involved stakeholders, as well as suspected participants, facilitators (especially important in money laundering scenarios) and also innocent witnesses. The initial phase is focused on fact-finding and data-gathering interviews. While methodical in

seeking to identify the chain of events, actions, participants, gains and harms, the guiding approach ought to be low-key and non-judgemental. The most effective interview methodologies are accretive and inquisitive, not accusatorial. As interviews unfold, they will expand in scope and narrow in focus. But it is critical that questioners fastidiously monitor and control each step of the process and also work to minimise interviewees from responding out of panic or diversionary intent.

Everyone on the response and recovery team has an important role. But none is more critically influential than senior managements'. If, as it is so frequently repeated, tone at the top can help establish a culture of compliance and ethics, so too will the response from the top set the course for recovery, or decline, following a malicious attack.

How do bank's senior leaders react when not only their roles and responsibilities but perhaps they themselves are scrutinised following a malfeasant event? What posture do they take when their institution is at risk of financial and reputational losses, securities trading declines or other negative fallout? Many large banks have clear codes of conduct providing explicit guidance in such delicate situations. Generally, they promulgate honest and unbiased investigations that protect the privacy rights of all concerned, all under the letter of the law. If these codes (as is the case in many institutions) are not widely preached, followed or believed by employees, they are not worth the paper they are written on.

In January 2016, Protiviti published the results of a survey⁹ that it had conducted assessing organisational readiness to deter, detect, investigate, and report fraud and corruption. It was targeted to an array of high-ranking institutional officers including chief compliance officers, general counsel, internal audit, outside counsel, senior leadership, and board members.

The results of the survey reveal that a majority of companies are not well-positioned to conduct proper fraud and corruption risk management and it questioned how effective organisations are at even identifying potential fraud. Key findings include:

- a substantial percentage of respondents claimed there had been no allegations of fraud or misconduct investigated over the past three years;
- only 27% of companies where revenues between US \$100 million and US \$9.9 billion provide anti-corruption training for personnel; and
- only one in 10 of respondents gave their organisations a high confidence rating for assessing and monitoring third-party corruption risk.

Effective fraud and corruption risk management must be comprehensively incorporated into every financial institution's overall strategic planning process. Fraud and

⁹ Protiviti Inc, *Taking the Best Route to Managing Fraud and Corruption Risks* (US: Utica College, January 2016).

corruption need to be discussed in the boardroom. A hear-no-evil-see-no-evil mentality is a derogation of board members' fiduciary responsibilities and should be summarily rejected in the corporate governance organ. Effective fraud prevention plans require significant investment of both human and financial capital, from inception and throughout implementation. They require ongoing developmental nurturance and support, especially as circumstances change. The success of any plan depends on organisational readiness to deter, detect, investigate and report fraud and corruption and also on the establishment of a culture of compliance and the engagement of staff at all levels of responsibility.

Effective compliance also depends on the tools available and the manner in which they are executed. In Pt 2 of this article, we will discuss the tools corporations regularly deploy in counter-fraud, anti-corruption, cybersecurity and general malfeasance threat mitigation and defence work. Of course, prevention and planning are no panacea for all ills; fraud can strike even the most compliant and well-prepared institutions. Once that happens, different sets of priorities, considerations, actions and disciplines are called for. Accordingly, we will also elaborate important approaches banking executives should consider regarding post-fraud detection responses. And finally, we will discuss whether financial profitability can realistically remain the priority of all financial institutions or whether a different model of banking is called for.