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Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC.

# Global Risk Watch Newsletter

## Narrower Paths for Major Central Banks Now Face the Risk of Being Clogged by Another European Shock, etc.

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<<index>>

1. # [Narrower Paths for Major Central Banks Now Face the Risk of Being Clogged by Another European Shock \(Tsuyoshi Oyama\)](#)
2. # [Consequences of Endless Misconduct by Major Financial Institutions \(Koichi Iwai\)](#)
3. # [Whether Inflated China Debt is Close to Crisis \(Toshikazu Kumagai\)](#)
4. # [Emerging Countries Business Risk Series -Cambodia- \(Hitoshi Motegi\)](#)
5. [Seminars, Conference & Publications](#)

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### 2. Overview of Development in Financial Regulations (Trends & Topics)

#### # Consequences of Endless Misconduct by Major Financial Institutions (Koichi Iwai, Senior Manager, Center for Risk Management Strategy at Deloitte Touche Tohmatsu LLC)

Recently, cases of misconduct by major financial institutions have been widely reported. Noticeable cases include coverage on the United States Department of Justice considering to charge a total of \$140billion fine (later reported that the amount has been reduced) related to Deutsche Bank's illegal sale of MBS (mortgage-backed security), and, in mid-September, the illegal and excessive sales activity by a US major bank, which was known as the winner of the financial crisis, and is being forced to change managements of the company. Especially in the case of the US bank, a various impacts will likely to be followed in the market going forward.

On September 8th, the US bank agreed with the Consumer Financial Protection Bureau (CFPB), the Office of the Comptroller of the Currency (OCC), and the Los Angeles City Attorney office on paying an \$185million fine and paying \$5million back to customers on illegal sales activity. Specifically, it became evident that, in the US bank's community banking business, after 2011 the bank was opening new checking and savings accounts without customer's consent and/or notification while also applying for credit cards and online banking services. Although the amount of fine was relatively "small", however the public was outraged by the scale of the fraud. As far as it is reported at this moment, nearly two million accounts were opened illegally.

In regards to the causes of such misconduct, detailed examinations and investigations by the bank's third-party committee and authorities should clarify the issue. However, one of the reasons is being pointed out that the bank's sales culture could have led to the misconduct. The bank have in the past, set a strategy to sell a wide range of products and services to retail customers and have strengthened the so-called "cross-sell" activity. Under this strategy, it imposed "cross-sell performance indicator" to sales staff, which in recent years, targeted to sell eight products per customer and used an incentive compensation scheme in accordance with employee's sales performance. Such aggressive sales culture is said to have created a corporate culture to refer to bank's branches as "stores".

We can see some differences when comparing the case of the US bank with other major post-financial crisis misconduct cases. Firstly as described above, the imposed fine from the authorities is "small", and the impact on the bank's financials is limited, despite the fact that this case has attracted enormous public attention. Of course, depending on future investigations by the authorities, there are chances of more severe fines or penalties, but still the view that these fines will significantly damage the bank's financial base is not common. The bigger concern is rather that the cause of the fraud related to the "cross-sell", which is the bank's "core" management strategy. This problem could be an indication that the bank was not able to manage the "strategic risk" sufficiently. The second comparison is that an ordinary bank employee conducted a fraud with common financial instruments. With respect to the past LIBOR (London Interbank Offered Rate) and FX scandals, some of the traders who were granted huge incentives were at the center of the fraud, but in the case of this US bank, an ordinary sales representative caused the problem. Therefore, it is widely viewed that the bank's "corporate culture" itself could have been the cause of the fraud.

Furthermore, criticisms have also become severe on financial authorities that are responsible for overseeing the US bank. In the US Congress hearing, tough opinions were raised against OCC and CFPB. Meanwhile, the supervisors are rushing to eliminate such criticisms. For example, OCC have announced that they will (1) urgently investigate whether similar issue is practiced amongst other financial institutions, (2) further promote the application of guidelines related to risk governance framework defined in 2014, and (3) urgently finalize the regulations related to incentive compensations.

At the moment, it is difficult to predict the consequences of this US bank scandal, however the following three points shall be considered. Firstly, to keep an eye on the change in bank's strategy management, the US bank has already decided not to use the "cross-sell performance indicator", but have not indicated any future retail business strategies. The newly appointed CEO is intending to address the strategy within the next few months. At the time of continued extreme low interest rates and difficult conditions for the banks to raise profit, the bank's retail business strategy has been a role model for financial institutions globally up until today, and it is noteworthy to keep an eye on how the bank will reform. Secondly, to follow the trend of the authorities, risk appetite, the nature of risk culture, and the effectiveness of the three lines of defence shall receive increased attention, as the OCC will perform stricter assessment on the guidelines related to risk governance framework. In addition to further investigation on the US bank itself, if similar fraud cases are confirmed in other financial institutions, financial authorities will most definitely take stringent actions. Especially given the upcoming election in the US, criticisms against big banks will become more stringent should the Democratic Party dominates the Congress and the Senate. Thirdly, the impact on the global regulatory developments, as introduced in last month's newsletter, the Financial Stability Board (FSB) is considering misconduct measures, which could turn into stricter measures given the continued cases of

misconducts by major financial institutions including the case of the US Bank. In any case, it could be stated that the US bank scandal have provided more reasons to reconsider the “culture” of financial institutions.

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