2 How does Conduct Risk Manifest and Who is Impacted?

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Introduction

We are still on shaky ground when banking and financial institutions concern themselves with conduct risk and a single definition or a comprehensive set of standards. Despite fines, new regulations and additional training of employees, outsize risks continue to be taken, and bonuses are maintained or increased. Boards of directors have begun to see conduct risk as a large threat though there is no one definition of it. After the 2007-2008 financial crisis exposed large ethical and cultural fissures that drove high risk behaviours, more attention began to be paid to conduct risk. The 2011 Financial Services Authority (FSA) Retail Conduct Outlook defined it as “the risk that firm behaviour will result in poor outcomes for customers.” In its seminal survey report in 2013, Thomson Reuters broadened the definition to “risks attached to the way in which a firm, and its staff, conduct themselves…. including “matters such as how customers are treated, remuneration of staff and how firms deal with conflicts of interest.” (Thomson Reuters, Conduct Risk Report 2013)

Regulatory oversight around conduct risk in the United Kingdom (U.K.) is far more advanced than in the United States (U.S.), where we study “people risk” as part of the Basel definition of operational risk; where Financial Industry Regulatory Authority (FINRA) has now defined the risk of “firm culture”; and where significant work has been done by the Carnegie Mellon CERT on “insider threats.” On both sides of the ocean, culture plays a large role. Regulators and scholars study the relationship between unethical behavior and executive tolerance of such behavior in the quest for higher profits. Whether we call it conduct risk or people risk, we are analyzing the same set of problems.

Two studies done by Labaton Sucharow, which surveyed British and American bankers, illustrate the challenge. [I wrote about these surveys in “Will We Always Have to Talk About Ethics?” in the June 2015 issue of The Risk Universe magazine have excerpted and added to it here.] The Labaton Sucharow 2012 Financial Services Industry Survey, titled “*Wall Street Fleet Street Main Street: Corporate Integrity at a Crossroads”* looked at 500 professionals, half from the US and half from the UK. No other study showed with such grim clarity how little impact the financial crisis and subsequent regulatory reforms had on banking behaviour for a statistically significant number of professionals. The report is worth reading still, since there is so much data to be analysed, but three pieces of information stand out. First, a staggering number (25% from UK and 22% from the US) felt it was necessary to behave illegally or unethically to get ahead. Second, around 16% “said they would commit a crime, such as insider trading, if they could get away with it”. The other significant issue in the 2012 survey was that fear of retaliation for reporting wrongdoing was still very high: “A startling 94% of all professionals surveyed said they would report misconduct if it could be done with a guarantee of anonymity, employment protection and a potential monetary reward”. In that 2012 report, Labaton Sucharow, a firm known for its prosecutorial work, concludes: “The best way to ensure the financial marketplace operates with greater transparency, fairness and accountability is to recognise the powerful troika – regulators, corporations and individuals – has the ability to establish and strengthen a culture of integrity that will create lasting change in the financial markets.”

Three years later, Labaton Sucharow released “The Street, The Bull and The Crisis: A Survey of the US & UK Financial Services Industry.” This time, the sample size more than doubled and 1,200 professionals in both countries were surveyed, representing “a broad spectrum of the industry, from young professionals to senior executives, investment bankers and investment managers, from San Francisco to Scotland”. (2015 report). In this report, statistics are higher when those who make more than $500,000 were surveyed. In the 2012 survey, 51% of those surveyed in the US were not aware of the SEC Whistleblower Program created by the Dodd- Frank Act, which offers financial compensation for reporting wrongdoing. Education seems to be proceeding at a slug-like pace, since 37% are still unaware of the programme even with this larger number surveyed. There’s even more data to sort in this second report and of particular interest is the pressure to compromise their own ethics that $500,000+ executives feel. A remarkable 33% of them “feel the industry hasn’t changed for the better since the financial crisis”. There is significant variance also in the data from those who have been in the industry for many years and those who are relatively new to it. What is new in both cases is the proliferation of agreements – for 25% of those who earn $500,000 or more and for 10% of others – that “would prohibit reporting illegal or unethical activities to the authorities”. And, in perhaps the most disheartening response of the new survey, 17% of all respondents “find it unlikely company leaders would report misconduct to law enforcement”.

When they look at regulators and law enforcement bodies in their respective countries, 39% find them ineffective; and that percentage rises to 49% when those who make $500,000 or more are answering. Individual and corporate integrity are fundamental components of effective risk management. Both studies indicate we have a very long way to go to change the culture inside banking. The C-suite is not making progress on the trust spectrum, or on communicating both values and acceptable behaviour to significantly reduce a firm’s losses from fraud or other forms of ethical misconduct. The troika that Labaton Sucharow identified in 2012 --corporations, regulators and individuals – has been unable to obtain the desired outcome(s).

Definitions

The Financial Conduct Authority (FCA) Risk Outlook 2013 created three domains – inherent conduct risk, structures and behaviours, and environmental factors, with three drivers identified for each of those domains. Though we will not review them directly here, the domains are relevant to any discussion of conduct risk on either side of the ocean.

In nearly every case we have seen, behaviours influence outcomes, especially where reputation and returns are concerned. Deliberately taking outsize risks in order to drive higher profitability is usually at the heart of the matter. Though there are single rogue players – Nick Leeson at Barings Bank or Bernie Madoff, for example, who brought down whole companies -- conduct risk is not usually attributable to a single player, but rather to a culture in which executives turn a blind eye to the activities of a few as long as the profits are there.

In its conduct risk special edition of *The Risk Universe* magazine in 2013, a senior UK risk manager points out how easy it is to simply regard conduct risk as behavioural. “In other words, as a formalization of the policies on ‘conduct’ that exist with the emphasis on: ‘are our staff, particularly those in the front office behaving...are they misselling? are they engaging in fraud?... are they perpetuating money laundering?... are they fit and proper?...are they complying with mandatory leave and mandatory training requirements? and other such concepts together with ‘what are the controls and metrics?’ that talk to these concerns.’” (“Déjà vu, 26)

Here, we identify and discuss the top three root causes of conduct risk – tone, culture, and conflicts of interest -- and then examine a concrete example of how conduct risk can manifest in a large financial institution, Washington Mutual Bank.

Root Cause #1: Tone

In its latest study for the Shared Assessments organization, titled “Tone at the Top and Third Party Risk,” the Ponemon Institute characterizes tone at the top as “a term used to describe an organization’s control environment, as established by its board of directors, audit committee and senior management. The tone at the top is set by all levels of management and has a trickle-down effect on all employees of the organization. If management is committed to a culture and environment that embraces honesty, integrity and ethics, employees are most likely to uphold those same values. As a result, such risks as insider negligence and third party risk are minimized.”

Owning a computer hardware company for 15 years was educational: an early project was the creation of an employee handbook that outlined issues that ranged from dress code to corporate values and acceptable behaviour. That handbook grew longer and then was edited in the interests of clarity over the years. The experience of owning and operating the small business, growing from several to over 20 employees, offered direct, hands-on conduct risk management lessons. My own personal ethics translated well to business ethics;

my integrity was on display in countless daily decisions made with employees on behalf of customers or the general public. Even in a small business, tone at the top mattered; and the "monkey see, monkey do" principle applied. Whether it is a small or large firm, the same principle applies: your policies and processes must align with the code of conduct articulated at the top.

Ten years at Washington Mutual offered a wider pathway. I began as the technology group's architect, mapping the firm's technology platforms, some of which were the result of acquisitions it had made by 1999; and then investigating the relationship between the programs and business objectives. The initial work involved identifying platforms or services that were redundant, to streamline the technology in support of corporate goals. Two years later, I became a senior vice president, responsible for business continuity, technology recovery, technology architecture, technology business intelligence and some elements of information security. Later, I also became responsible for technology change management and for the technology group's relationships with audit and regulatory assurance. You could say that the work touched most of the business practices of the company, including the formal deployment of internal banking and finance controls that are at the heart of enterprise risk management. At its height, the firm had over 60,000 employees. It had a strong code of conduct, and articulated corporate values ("fair, caring, human, dynamic and driven"). It had strong employee communications and online training programs in such areas as conduct, security and business continuity that all employees had to complete annually. Yet with those ten years came some brutal lessons on just how difficult it is to manage risk when a company is siloed, with both its board and its regulators under-informed.--- As will be clear from the section here titled "An American Example," Washington Mutual's strong desire to satisfy Wall Street led to a series of mergers (29 in all, after the bank was de-mutualized) with other banks. Such mergers looked like financial growth, but led to real instability in re-organized lines of business when "new employees" from the acquired companies were not sufficiently trained in the bank's core values. Meanwhile both the board of directors and two sets of regulators – the U.S. Office of Thrift Supervision and the U.S. Federal Deposit Insurance Company – underestimated the risks of such expansion, particularly in the subprime mortgage market.

Subsequent work as a consultant for critical infrastructure companies has broadened an understanding of the challenges in both the public and private sector. One of the first pieces of due diligence performed for a client is to discover whether or not a code of ethics is in place, and well-understood by employees; whether new employees receive an orientation on corporate values and ethical behaviour; and whether there are reliable and well used reporting programs in place. Though research continues around the question, there appears to be no perfect example of conduct alignment at both the top and the middle or bottom of a company. Employees have an increasingly difficult time believing that executives share the same values and commitment to a code of conduct. In the workplace, whether on the front line or at the senior management level, daily practices are closely observed by employees in order to understand how they should behave. In the risk assessment for The Global Fund, Joan Elise Dubinsky from the Rosentreter Group defines culture as "the shared assumptions of what members of an organization believe and how they work together to reach shared goals. Groups need to consider their culture consciously, especially at times of rapid change and growth, and when confronted with integrating newcomers quickly to the group." (Dubinsky,9) This point cannot be emphasized too strongly: integrating a range of conducts and values into a financial entity that continues to grow puts the organization at high risk.

Root Cause #2: Culture

"Change in culture will only come when the tone at the top is right. However, it also requires staff throughout a business to understand and accept the values and practices the firm espouses. This means that firms must ensure that all of their processes support and reinforce the culture they want to promote. Some examples include firms' remuneration, hiring, performance management and promotion decisions, as well as how they treat internal reporting of concerns, the level of responsibility the first line takes for the right outcomes and the autonomy and empowerment of key control functions. We have a range of tools at our disposal to actively combat any poor conduct by firms and individuals." (Chairman's Foreward, FCA Risk Outlook 2014/15)

"While firms may have their own definition of 'firm culture,' we use it here to refer to the set of explicit and implicit norms, practices, and expected behaviors that influence how firm executives, supervisors and

employees make and implement decisions in the course of conducting a firm's business." (U.S. Financial Industry Regulatory Authority (FINRA) 2016 Regulatory and Examination Priorities, January 2016)

For many of us, ethics can be equated with doing what we say, with mirroring in our behaviour the values we espouse. In today's business environment, that can be trickier than we think. Moral trade-offs seem sometimes to have become the norm. The characteristics and practices of the workplace provide the context in which a number of choices are made daily by employees. Change the workplace and you may find that the behaviour changes also.

New employees adapt to the workplace by observing its culture and the behaviour of others both in the group to which they are assigned, at by observing executive conduct from various distances, based on one's place in the firm. As Sheedy points out in Chapter 5 of this volume " This typically happens informally; we learn from the verbal and non-verbal responses of others, especially those who are highly respected. Most learn how to behave by observing what others do rather than by reading procedure manuals, policies and value statements. This is particularly true when it comes to ethical dilemmas where it seems that most people react automatically or intuitively based on social cues. Very few people apply the careful deliberative process used for anlysing ethical dilemmas in educational settings. (Reynolds, et. al., 2010)" Sheedy's work reinforces the "monkey see/monkey do" behaviour that seems baked into the world of finance.

How does that culture of impunity at the top affect employees' perceptions of their workplace and their own behaviour? It is when the pressure heats up – new financial targets, acquisitions of other companies, high risk strategies for growth and innovation – that the group leader might indicate that it's acceptable to cut corners. There is no doubt that group behaviour causes employees to behave uncharacteristically. CEB RiskClarity estimated that "one in four employees observed misconduct or were uncertain if they observed misconduct last year. Of those observations, only 17% will find the compliance and ethics office." (https://www.cebglobal.com/compliance-legal/risk-clarity.html?referrerTitle=About%20CEB%20RiskClarity&.html)

Those findings align with the Labaton Sucharow studies discussed earlier and with the 2013 Ethics Resource Center report, where more focus is put on why employees at lower levels or even middle and senior managers decide not to report wrongdoing when they observe it. Just as employees observe and do not report misconduct by others, they also observe others reporting misconduct. If the 2013 Ethics Resource Center Report is correct, that sixty per cent of the violations were observed to be committed by managers and/or executives, then it's pretty clear why such fears as loss of a bonus or of retaliation and/or loss of one's job affect a firm's best attempts to provide a pathway through something like a misconduct program like whistleblowing. In the United States, the Securities and Exchange Commission (SEC) laid out a program of financial incentives for those who report. It is too early to know if such programs will be successful.

Large organizations other than banks also struggle with culture and tone. In some relatively rare cases, CEOs are removed from their positions by their boards of directors. Note that not one of them on this list is a head of bank; and that each CEO was fired for what can generously be called risky personal behaviour.

2008Former corporate board member/McKinsey CEO Raj Gupta (securities fraud)
2010 British Petroleum CEO Tony Hayward (external event)
2010 Hewlett Packard CEO Mark Hurd (falsifying reports)
2012 Highmark CEO Kenneth Melani (junior employee)
2012 Best Buy CEO Brian Dunn (personal misconduct)
2012 Lotus CEO Dany Bahar (financial mismanagement)
2014 American Apparel CEO Dov Charney (sexual harassment)

Of this list, only Raj Gupta went to jail and paid a large fine. While it's possible that in the other non-banking cases regulators played some role in recommending the removal of the CEO, it was actually the boards that acted. In a New York Times/ProPublica magazine article, Jesse Eisinger examined why no banking executives went to jail as a result of the 2008 financial crisis. (Eisinger, "The Fall Guy," April 30, 2014) The article is a detailed look at changes in the U.S. Department of Justice as well as at the country's more favourable view of large businesses. As Eisinger points out the focus at the Justice Department was on winning settlements, not convicting executives: "Still, while the Department of Justice has not been without its successes – it won a guilty plea from BP in the Deepwater Horizon spill, and it's gone after traders in the wake of the JPMorgan Chase London Whale trading loss – these remain exceptions even beyond the financial sector. Federal prosecutors almost never bring criminal charges against top executives of large corporations, from banking to pharmaceuticals to technology…. As the economy limps back from the Great Recession, compensation has recovered, corporate profits are at record levels and executives see that few, if any, of their peers ever go to prison anymore. Perhaps one reason Americans have come to begrudge the wealthy is a resentment of their culture of impunity."

Why should we expect lower and middle level managers to report misconduct, especially if it is of their superiors? Is it reasonable to expect culture will evolve as a result of reporting when bonuses are at stake? How many executives in the banking industry are fired for misconduct? One might ask if it is only what Sheedy calls "a few bad apples" that contribute to culture risk, or if it is something even more complex that is borne out of working as a member of a team in the financial marketplace. When the personal or group benefit is so attractive as to ignore controls and regulations that are in place, how can we say no? In most financial workplaces, we are anxious to hire those who commit to teamwork, rather than individual contribution. Since we value corporate loyalty and corporate teams so highly, we need better tools to understand when that team turns toxic.

Root Cause #3: Conflicts of Interest

Although the FCA 2013 Risk Outlook identified conflicts of interest as a plausible driver of conduct risk, the examples presented are concerned with the sale of products and retail financial transactions and the ease with which a retail product becomes too complicated for the customer to understand. A "conflict of interest" is defined in a wide variety of professional codes of ethics commensurate with the particularities of a profession, but here we might use the definition from the Oxford English Dictionary: *"A situation in which a person is in a position to derive personal benefit from actions or decisions made in their official capacity:"*

The definition illustrates the large gap between the language of finance and the language of ethics. Terms such as right and wrong are situational and conditional, different than the world of finance where numbers are black and white, and measurement is usually against financial profit or loss. Yet in the evolution of the definition of conduct risk, we begin to see light at the end of tunnel where both British and American regulators are concerned: "A firm's culture is both an input to and product of its supervisory system, including its approaches to identifying and managing conflicts of interest and ensuring the ethical treatment of customers." Whether one relies upon her/his own personal ethics or upon regulation, workplace practices are as random as the instances of the application of an ethical framework to make a complex corporate decision.

So what, exactly, could "personal benefit" look like where official decisions are concerned? Conflicts of interest at the upper levels of management often occur because of a rather firm belief from senior management that they have made the right decision even though it may take some time to pay off. The twin external pressures of media scrutiny and market competition drive decisions to maintain a strategy that has been implemented without much tweaking so that personal bonuses will be paid. The question does not become "What is the right thing to do here for our shareholders?" Rather the question becomes "Can we get over this hump to get paid?" When profits nosedive, there is concern both to retain top talent (retention bonuses) and to find new sources of profitability to report quarterly to the regulators and to the street. For JPMorgan Chase's CEO to describe what would later balloon to be called "the London Whale" event as "a tempest in a teapot" on a quarterly call is illustrative. The failure of JPMorgan Chase's executive risk team or its operating committee to identify and halt sooner what turned out to be a $6 billion loss from the investment office has many tentacles, some of which involve tone and culture but others that come down to conflicts of interest. Hiring the brother-in-law of a member of a bank's operating committee to be the risk officer for the investment bank might be considered bad judgement or inappropriate, but there is no doubt that it is also a conflict of interest between what is best for the Chief Investment Officer and what is best for the bank. But she hired him because, as Susan Dominus' 2012 New York Times profile of Ina Drew[i] points out, she trusted him and had known him for years. This is a sober lesson and one all too often overlooked where conduct risk and conflicts of interest are concerned: we hire people we trust, or people whom we believe think like we do. And when matters get rough, we tend to huddle like-minded executives or mangers together to reinforce actions we've decided to take. This is perhaps the most pernicious side of corporate think and group dynamics: we all agree to agree after we've shared our disagreements, and we agree then to keep those disagreements to ourselves, whether or not they represent a conflict of interest. Even though we have an official capacity, we fall back upon decisions that favour personal benefit at the highest levels of the company.

Though JPMC did not go out of business like Barings, it did end up with losses and paying in excess of $6 billion -- $150 million in securities fraud fine and a $6.2 billion trading loss. In both cases, one could argue that culture, tone at the top and at least the appearance of a conflict of interest is what drove unprecedented conduct risk. While one could argue that a trader's long term professional interests would have been better served by reporting those losses as they occurred, we also know that such reporting would compromise those to whom it was reported if they did not act immediately to continue to report it up the chain of command and to fire the trader(s). Yet information gets stuck at lower levels, often not all the way up the chain, because with knowledge comes concern over losing the annual bonus. The conflict between professional gain (the bonus) and reporting large losses becomes even more attenuated for members of a team, whose performance is measured for results. At each level of reporting up the chain, negative results become more sanitized, often to the point where members of the C-suite can state for the record that they were not aware of the severity of the problem at the time.

We don't see this dichotomy so much on the front line. Corporations such as Starbucks have focused much of their training on placing a high value on customer service, on incentivising employees to ask "what is best for the customer?" There is a great deal that banks could learn from the training protocols that Starbucks uses for its front line. Yet it must be pointed out that financial misconduct in banking occurs most often higher up in the firm than the front line. For the front line, serving up coffee or a financial transaction, there is very little left to the imagination. Such training of the front line clearly shows what is and what is not legal or even culturally permissible, and is designed to reduce or eliminate the possibility of fraud.

Profound pressures upon an individual which are in direct contrast to the best interests and financial viability of the firm may also cause conflicts of interest. Shortcuts may be taken, as in the instance of Barings Bank trader Nick Leeson, when he made increasingly outsize bets to try to get back to the profit side of the books over three years. It appears that it went on that long because manipulations of the data were easy. He would have said that, at that point he was working in the firm's best interests, that executives created an effective foil between himself and the asset liability committee, which was not allowed to question him. "You become coloured by what you see," he said. "Everyone bought into the success story, was focused on the bonus. It is a matter of dispute whether Leeson enjoyed personal gain, but he kept making the trades out of a fear of failure, operating out of Singapore from what he called a "tissue of lies vs. reality." "(OpRisk World conference keynote speaker, 2014) Like Toshihide Iguchi from Daiwa Bank, who pleaded guilty to losing $1.1bn in trading US bonds over 12 years, he was also concerned about personal dishonour, which he characterized (like Leeson) as letting down other members of his team. (OpRisk World conference speaker, 2015)

An American Example

Perhaps a specific case can illustrate how conduct risk manifests and what the most extreme effect of conduct risk looks like, the failure of an American bank. The rise and fall of this bank, where I was a senior executive, was chronicled in Kristen Grind's book, *The Lost Bank: The Story of Washington Mutual—The Biggest Bank Failure in American History*,[ii] which I reviewed and from which edited portions are excerpted and updated here (Searle, "Reflections on the Lost Bank," *The Risk Universe,* July 2012). Rather than focusing on the larger economic meltdown in 2008, Grind's book examines how Washington Mutual's strategy, culture and risk appetite underwent a significant change over 20+ years, as it moved from a regional thrift, to seeing itself as having the potential to become what was called a "category killer."

Having accomplished large and successful mergers on the retail bank side in the 1990s, it's not surprising that Washington Mutual's values grew from three – "fair, caring and human" -- to five --add "dynamic and driven" -

- when it began to acquire home loans companies as part of its growth strategy.   Marketing for the retail bank, commercial and home loans (and later, the retail card) divisions was handled within each respective silo, but with a playful emphasis on customer service and ease of use. As if to prove that unstuffy non-bank image, the bank's name contracted, from "Washington Mutual" to "WaMu" in 2007.

People: There was no one person who brought down Washington Mutual. It was a culture change that began when the bank brought on senior executives accustomed to other corporate values, particularly from acquired organizations. The strategy shifted from acquisition of retail banks that expanded the branch footprint and deposits, to the acquisition of banks with home loans platforms.   The drive to modernize technology led to the hiring of an Australian bank CIO, who understood the mortgage market from his time at Countrywide Financial. Grind describes how additional hires were made at the executive level from respectable institutions like General Electric and JPMorgan Chase. (Grind, 98-99). Though he may have been pressured earlier by the board of directors and by the leadership development books popular at that time, Killinger took until 2004 to decide upon a COO, perhaps realizing he would lose his close oversight of the executive team. His choice of an outside COO cost him most of the members of the original executive team that had driven growth on the retail side.

Process: The single greatest change to organizational processes, especially at the executive level occurred when Killinger decided to break up what had been a dynamic executive team by creating divisions of the company in 1999. It did not take long for those divisions to become silos, both in their business processes (some broken with the reorganization) and in their use of technology.   It was not only the team, but also the need each silo felt to ramp up its own unique set of applications and vendors, rather than to operate across divisions. Each of the three lines of business maintained their own office and branch infrastructure for some years, as if to reinforce the silos, while unprecedented growth continued to take place. When Washington Mutual purchased a Providian Financial in 2005, it created a fourth line of business where risk exposures to the credit card business were under-calculated.   Though an Enterprise Risk Management program was created, headed by former WaMu CFO William Longbrake in 2002, it took several years for failed business processes to be identified within the siloes and for process duplication to be eliminated unless requested by regulators, who also examined the bank from a silo-based safety and soundness practice.

Systems: Though efforts began in 2001 to clean up the bank's multiple business applications and upgrade its hardware platforms, the side effects of multiple acquisitions showed up most clearly in the spaghetti-like schematics of the bank's technology architecture. Streamlining could only be performed if banking units were sure that moving their application would not in any way jeopardize its operation or if the technology costs were too high. The regulators expressed concerns over home loans financial results because the group was operating, at least at one point, with at least a dozen different lending platforms. The Home Loans Group later wrote down at least $150 million against its own proprietary home loans platform, called Optis, which had been seen as a game-changing platform, an all-in-one home loans system. Developed on a contract with Accenture, and with the enthusiastic partnership of the technology group, Optis was later described by the regulators as "a significant management/technology failure." Grind points again to the perils of silos: "Because the Home Loans Group had ownership of the project and it was carried out within that silo of the bank, some WaMu managers and executives didn't know the extent of the problems. Others who offered help were turned away."(Grind, 100-101) It was hard to resist the power points – Optis looked like a dream machine that would also put a feather in the cap of the technology group. From at least my perspective, a great deal of what would become the "think big" behaviour that later became reckless risk-taking started here. As a 2004 CNN article pointed out, Washington Mutual lost ground to competitors because "Optis worked well for processing mortgage applications, but it failed in the far more important tasks of processing, underwriting and closing the loans."[iii] Credit reports, credit scoring, and mortgage applications themselves were all found later to have been part of the problem as mortgage brokers pushed "the power of yes" through substandard mortage platforms.

External Events: In a fine irony, Killinger had prophesized the bank's demise in 2003 when he said that "We hope to do to this industry what Wal-Mart did to theirs, Starbucks to theirs, Costco did to theirs and Lowe's-Home Depot did to their industry. And I think if we've done our job, five years from now *you're not going to call us a bank*."[iv] Five years later, a version of his prophesy came true. In a letter to friends and family written after Grind's book was published, subsequently reported in the New York *Times*, Killinger laid out what he perceived to be major inaccuracies in *The Lost Bank.* After detailing measures that the board and management took to reduce home loans from 2003 to 2007, and to raise new capital in 2007-2008, Killinger expresses his view that the book "largely misses the point that most sophisticated participants in the financial industry failed to accurately predict the extent of the national housing downturn….Any fair recounting of the financial crisis would note that any errors made in failing to anticipate the severity of the housing collapse were made collectively by the entire financial industry and the government….It is a gross understatement to say that I am greatly saddened that the company is not here today and that it was not provided the many benefits and programs that were so beneficial to large Wall Street banks when the financial crisis reached its peak."[v]

Roger Lowenstein's excellent book, *The End of Wall Street***,** provides us a full characterization of that entire environment, as Killinger suggests Grind's does not, but he [Killinger] cannot be much happier with his portrayal in that book. In that book, Lowenstein suggests that as early as 2005, *"With success coming so easily, WaMu was deaf to the need to monitor its risk" and as early as that same year "…with Killinger, the rising tide of risk tolerance loosened his moorings."*[vi]

Clearly the leaders at Washington Mutual seemed unable to course correct the growth strategy and dial down their exposure, even though all the key risk indicators were there as early as late 2006. In the long run, we have to ask why the strong bench that had been assembled couldn't see it coming. Several former chief risk officers had raised questions on the housing bubble and on subprime mortgages as early as 2003. Large firms like JPMorgan Chase and Goldman Sachs had begun to significantly reduce their exposure to risk from other banks and to the subprime mortgage business late in 2006. Washington Mutual rejected JPMorgan Chase's offer of $8 per share in March of 2008, thinking the bank had sufficient capital after a new infusion to see it through the bottom of the mortgage crisis. As runs on the bank began to erode its liquidity, and as various ratings downgrades occurred, executives at Washington Mutual continued to believe that things were going to turn around. Books like Lowenstein's document the chaos in other parts of the economic environment of 2008: Fannie and Freddie and AIG had been propped up or bailed out; Lehman had failed; Bear Stearns was acquired at fire sale prices by JPMorgan Chase and now the FDIC was letting other banks know that Washington Mutual would soon be available for bid. Lowenstein characterizes this period in a few sentences: "During the third week of September, the week of the TARP debate, all went silent. WaMu could not figure out why its calls to suitors were going unanswered. The reason was that the federal regulators had preempted the auction." (Lowenstein, 236) It was too late, despite efforts by Alan Fishman, the East Coast CEO hired that month to replace Killinger. Banks strong enough to consider making the acquisition were waiting to see when the sale would begin. From Grind, describing FDOC director Sheila Bair's later testimony, "In the FDIC's view, WaMu's closure was a success. Not a dime of the deposit insurance fund had been used in connection with the largest bank failure in U.S. history. The government isn't charged with protecting bank shareholders or employees. Its job is to protect customers."(Grind, 315) For customers, the FDIC had done its job: its deposits were insured and their funds were safe. For shareholders, vendors, and other investors, the losses on the sale of Washington Mutual were vast, the direct result of conduct risk at both the executive and the board of directors levels.

In the epilogue to the book, where Grind amplifies on how little noticed was the failure of Washington Mutual in the larger context of the economic collapse, she notes of Killinger's Congressional testimony in 2010 that "former executives and managers of WaMu watched the congressional grilling, thinking nothing unusual of Killinger's responses. It was entirely possible, they believed, that Killinger didn't know what was happening*. He had continued to believe that the risks the bank took could be managed. He couldn't see how his strategy decisions, made at the highest level of the company, had created a poisonous lending culture at the bottom."* (Grind, 330)

The United States Senate Permanent Committee on Investigations issued a 531-page report in April of 2011[vii] that calls out conduct risk by both Washington Mutual and by its primary regulator, the Office of Thrift Supervision (OTS). The report includes a case study on Washington Mutual that lays out its high risk strategy, summarized thusly: "Documents obtained by the Subcommittee reveal that WaMu launched its high risk lending strategy primarily because higher risk loans and mortgage backed securities could be sold for higher prices on Wall Street. They garnered higher prices because higher risk meant the securities paid a higher coupon rate than other comparably rated securities, and investors paid a higher price to buy them. Selling or securitizing the loans also removed them from WaMu's books and appeared to insulate the bank from risk.

"The Subcommittee investigation indicates that unacceptable lending and securitization practices were not restricted to Washington Mutual, but were present at a host of financial institutions that originated, sold, and securitized billions of dollars in high risk, poor quality home loans that inundated U.S. financial markets. Many of the resulting securities ultimately plummeted in value, leaving banks and investors with huge losses that helped send the economy into a downward spiral. These lenders were not the victims of the financial crisis; the high risk loans they issued were the fuel that ignited the financial crisis." (Senate Report, 4)

In his summary of findings around the bank's chief regulator, the Senate report spoke to the level of conduct risk and regulatory failure like this: "OTS displayed an unusual amount of deference to WaMu's management, choosing to rely upon the bank to police itself in its use of safe and sound practices. The reasoning appeared to be that if OTS examiners simply identified the problems at the bank, OTS could then rely upon WaMu's assurances that problems would be corrected, with little need for tough enforcement actions. It was a regulatory approach with disastrous results." (Senate Report, 5)

The failure of Washington Mutual, the nation's sixth largest bank and largest thrift, was too new to be included as a textbook example in Jim Collins' book, *How The Mighty Fall and Why Some Companies Never Give In*[1viii], published in 2009, though Collins does spend some time discussing Fannie Mae as well as earlier cycling at Bank of America. The book outlines in Shakespearean mode the five stages of corporate decline, which bear a remarkable resemblance to the rise and fall of Washington Mutual, one of the largest banks in the United States, one that: "1) Hubris Born of Success; 2) Undisciplined Pursuit of More; 3) Denial of Risk and Peril; 4) Grasping for Salvation; and 5) Capitulation to Irrelevance or Death." Interestingly enough, Collins' books were studied by leadership and the board of directors, in the drive to become a great company, a category killer. Collins' earlier books, *Good to Great* and *Built to Last*, did not study Washington Mutual, probably since its growth spurts did not fit well in companies profiled in either book. But Collins books were promoted to Washington Mutual senior management, as part of our reading list on the way to becoming a "category killer."

From this most extreme single example of Washington Mutual, it's possible to understand how conduct risk can manifest, how matters careened off track in roughly eight years. Culture change as well as external events can align to create the path to seizure by regulators. Asking for help may appear to be a sign of weakness, a fear of failure. All too often, a firm's three lines of defense are populated by employees with financial backgrounds, ill-equipped to identify or propose mitigation around conduct risk. A 2011 study by The Corporate Executive Board (CEB) RiskClarity showed how much better companies performed financially when they had focused programs to identify unethical behaviour and correct it: on ten-year shareholder returns, higher integrity companies outperform others by 16.2%.

Reducing Conduct Risk

In an article titled "Ethical Misconduct: Is It Your Biggest Risk?" written for The Risk Universe in November 2012, I suggested six steps that could be taken to reduce misconduct:

1. **"Review the corporate values/vision statement.** Is it a marketing slogan, directed at customers and investors, or is it a statement of values, written to be intelligible to employees and pointing to desirable behaviour? Companies like Nordstrom and Starbucks have embedded their corporate values and their mission statements in front line employee behaviour.
2. **Create/review the code of conduct.** Sometime ethics boils down to deciding what to do when there isn't an absolute rule or regulation. Sometimes ethics boils down to reporting misconduct rather than taking the low road. Simply following the regulations sets a very low bar. Use the values statement and the code of conduct to put a real communications program together that uses storytelling around appropriate and inappropriate behaviour. Make it more than a one-time orientation with an annual online check-in.
3. **Incentivise employees to do the right thing.** Recognize exemplary conduct. Storytelling is an effective way to make the ethical point – find employees who did the right thing even when there was

no specific rule to follow or someone watching. Periodically recognize teams who perform well. Include ethical conduct as a percentage of bonus annually, either at the individual or group level. And be sure that HR profiles managers inclined to retaliate against employees who report misconduct. If they cannot correct their own retaliatory behaviour, they should not be managing people.

4. **Build a fraud and misconduct plan.** Conduct a misconduct risk assessment. Identify weaknesses and create a mitigation plan as well as a response team. Train employees on how to report misconduct or fraud by identifying what it is. Develop a program that includes triggers to move a report from an "allegation" to an "investigation." Make clear to staff and managers that retaliation from reporting is unacceptable in every way.
5. **Create your own program.** The revised U.S. Securities and Exchange Commission (SEC) whistle-blower program assumes that with stronger cash incentives, there will be a higher level of participation. But why not create your own program and reduce your own reputational risk directly? An internal whistle-blower program that guarantees anonymity, employment protection and a monetary award is a best practice. Consider also what I call, for lack of a better term, an "I Made a Mistake" program that allows employees to self-report unethical decisions or behaviour without being punished or retaliated against. I believe there could be a lot of room here for building such a program's requirements and scope. It is worth considering, even if the first year only brings reports of pilfered office supplies. If you deploy online training, then use lots of scenarios and multiple choice options.
6. **Ask your senior leaders to reinforce ethical conduct verbally and with their own performances.** If your leaders aren't behaving in an exemplary fashion and modeling the behaviour they wish to see from employees, it's hard for employees to take ethics issues seriously. In this respect, misconduct by leaders could include cutting corners, manufacturing data, waiving requirements or eliminating critical risk practices."[ix]

It is fear that drives employees to misconduct – aggrieved that they are not appreciated, fear that they will not get their bonus, fear that they will not be promoted, fear that they will not have enough money, and, in today's climate, fear that they will be fired. As a leader, what can you do? Your behaviour can exemplify the code of conduct and the corporate values. Above all, you can create a climate for your team to ensure that members are not afraid to give you bad news. You can learn to say "I was wrong" and "thanks for your insight." This is not exactly the same as ensuring that you never retaliate against an employee who reports misconduct, but it is close. To succeed as a leader yourself, you need to remove as many of these fears as you can, to unleash as much productivity as possible, and to make it possible, through the climate you create for employees, to take well managed risks that will pay off for the company. Finally, you need to give your superiors the best advice available in those tough situations.

Reducing the occurrence of conduct risk will continue to be one of the great challenges of the financial sector.

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