HERBERT SMITH FREEHILLS

CULTURE CLUB
2018 GLOBAL BANK REVIEW

Contents

L to R: Tony Damian and Andrew Procter.

Welcome

Welcome to our second edition of the *Global Bank Review*. This is a publication by our Global Banks Sector Group, which brings together people at Herbert Smith Freehills from around the major financial centres of the world whose practices touch the wide range of activities undertaken by banks.

The last 12 months have been significant for banks around the globe, many of whom have been considering complex yet important questions around culture, and doing that while under acute public scrutiny. Those banks have also had to consider the practical aspects of how to manage the risk of misconduct amidst a rapidly evolving regulatory landscape. As such, culture, regulating culture, and the "Culture Club" seemed a fitting theme for this year's edition.

Our feature article puts "Banking culture under the microscope" and delves into the Financial Stability Board's toolkit for strengthening governance frameworks and mitigating misconduct risk. The article explores where to start when embedding culture across an organisation, and the issue of prevention rather than cure.

We have sought the views of leading in-house lawyers to see what it is like being a General Counsel in this "culture age", and have also kept abreast of Australia's Royal Commission into banking misconduct, in which banking culture, and how to regulate it, has been a driving theme.

Financial technology continues to be a significant growth area; however, Fintechs have traditionally been viewed as a source of disruption to the sector; to established banking institutions in particular. We look at the growth of RegTech, and test whether collaboration between emerging Fintechs and established banks could actually be a quick route to successful innovation, despite the regulatory hurdles.

Anti-Money laundering is another important topic for the sector. We explore the emergence of crypto-laundering, and how convertible virtual currencies that can be exchanged for real money or other virtual currencies are potentially vulnerable to money laundering and terrorist financing.

The focus on culture as a critical risk indicator has meant that employee well-being and mental health is now starting to appear on bank board agendas across the globe. Longer hours, leaner teams with heavier workloads, and rapid regulatory and technological change have all been cited as increasing pressure on employees in the banking industry, and the prevalence of mental health conditions is on the increase.

Finally, a review of the global state of play for the bank sector would not be complete without reflecting on the 10 years since the Global Financial Crisis. We asked some industry leaders to share their own personal experience of living through the GFC, the impact on the sector, how they feel things have changed in the 10 years, and what they see as the challenges to come.

On behalf of the firm and the Global Banks Sector Group, we hope you enjoy reading this second edition of the *Global Bank Review*.

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Banking culture under the microscope: Prevention is better than cure

At a time of acute public scrutiny into the culture of financial institutions, a new 'toolkit' issued to member jurisdictions of the Financial Stability Board provides food for thought. The toolkit gives some practical insights into how financial institutions can manage the risk of misconduct through developing and maintaining a robust compliance culture. It also includes interesting insights into how global regulatory expectations in this area are likely to evolve.

In April 2018, the Financial Stability Board (FSB) published a report to its member jurisdictions for the purpose of providing both financial institutions and their regulators with a toolkit for strengthening governance frameworks and mitigating misconduct risk.[1]

The intent of the FSB is to find ways to prevent problems before they escalate to investigation or enforcement, through assessing firm culture and driving organisational change.

Many of the proposed tools could have an impact far beyond traditional compliance and legal departments, instead reaching into business divisions and those that support them, such as human resources, communications, strategy, and compensation. The tools also point towards the adoption of a more holistic approach to compliance, including through vision creation, culture and employee surveys, and utilising a myriad of new data points for analysis.

While much of this thinking is already embedded in some regulatory regimes, some elements are more novel and may be challenging for organisations to incorporate. That said, we are already seeing regulators moving to incorporate some of these features of the toolkit into their supervisory approach and we expect the regulatory focus on this area to continue into the foreseeable future.

Three key areas of concern for the FSB

1. The role of poor culture in driving misconduct within a financial institution.
2. The lack of individual responsibility and accountability.
3. 'Rolling bad apples', where individuals move to another financial institution without their earlier misconduct being disclosed to their new employer.

Relevance of the FSB's approach

Unsurprisingly for a body set up by the G20 in direct response to the financial crisis, and charged with promoting global financial stability, the FSB has been instrumental in driving post-crisis regulatory reform.

While its work is not strictly binding on G20 member states, experience suggests that regulators see the FSB's recommendations as a guide to best practice and tend to implement it.

With that in mind, the FSB's toolkit is relevant both because it provides tools to assist firms in enhancing their culture and because it indicates how regulatory expectations on culture are likely to evolve. The toolkit is designed primarily for banks. However, many of the regulators responsible for implementing FSB measures have responsibility for a much wider group of organisations. As such, measures proposed in the toolkit are likely to extend quickly across the broader financial services industry.

The toolkit sets out 19 tools for use by regulators as well as organisations, with these tools straddling three key areas of misconduct risk. These areas are: the role of poor culture in driving misconduct within financial institutions; the lack of individual responsibility and accountability; and the problem of 'rolling bad apples' (where individuals move jobs and earlier misconduct is not disclosed to the new employer).

Some of the tools are familiar – increased cross-border coordination between regulators, and the increasing focus on individual accountability, for instance.

Less familiar to many will be an emphasis on enhanced recruitment screening, interview techniques, performance review and a rolling in-depth 'psychoanalysis' of a firm's culture.

Bad people or bad culture?

When does an individual's bad behaviour become the firm's bad behavior or culture – and vice versa?

The toolkit is, in many ways, a response to concerns that have arisen since the time of the global financial crisis.

Regulators are acutely aware of public and political criticism that some financial institutions and their senior executives have escaped unscathed (and undeterred) from instances of wrongdoing that

"Federal prosecutors should be cautious about closing investigations in return for corporate payments without pursuing individuals who broke the law."

US DEPUTY ATTORNEY GENERAL ROD ROSENSTEIN

contributed to the financial crisis. In fact, as noted in the preface to the FSB's report, since the financial crisis began, global banks have paid fines and incurred legal costs of more than US$320 billion. However, while significant penalties have been imposed, and those penalties are intended to (and do) act as deterrents, the mere fact of penalties in that order of magnitude contributes to further undermine confidence in the financial sector.

Recent scandals, such as Wells Fargo's account opening incentives, have only heightened the public perception that nothing has really changed. Regulators are therefore under increasing pressure to 'crack down' on poor cultural behaviour.

Some regulators have responded to these political pressures by shifting their focus from institutions to individuals.

New laws such as the UK's Senior Managers Regime, Australia's Banking Executive Accountability Regime (BEAR) and Hong Kong's Manager in Charge Regime seek to address the issue through requiring the identification of those responsible for key areas of a financial institution's business lines. Similar senior manager accountability regimes have also been proposed for Singapore and Malaysia, and are scheduled to be fully implemented in 2019. These regimes are designed to make it easier for regulators to identify those responsible for overseeing misconduct when it occurs. Whilst often not their stated aim, we are already seeing signs that these new regimes will be a powerful aid to regulators, allowing them to better target disciplinary and enforcement action at individuals where appropriate. For example, the Hong Kong Securities and Futures Commission recently remarked that while it did not originally see its Manager in Charge regime as an enforcement tool, they have come to see it as useful for this purpose as it helps them hone in on individual culpability sooner.

Prosecutors around the world have also emphasised their focus on individual accountability and liability. In October 2017, US Deputy Attorney General Rod Rosenstein reaffirmed Department of Justice policy in this area to an audience at New York University[2]: "Federal prosecutors should be cautious about closing investigations in return for corporate payments," he said, "without pursuing individuals who broke the law."

However, only six months earlier at the same venue[3], Mark Steward, Head of Enforcement and Market Oversight at the UK's Financial Conduct Authority (FCA), made an equally important point, "that the question of firm or individual liability is not a simple binary either/or question of policy or attitude."

Disentangling culture

The FSB suggests a range of practical ways for firms to grapple with the relationship between individual behaviour and corporate culture.

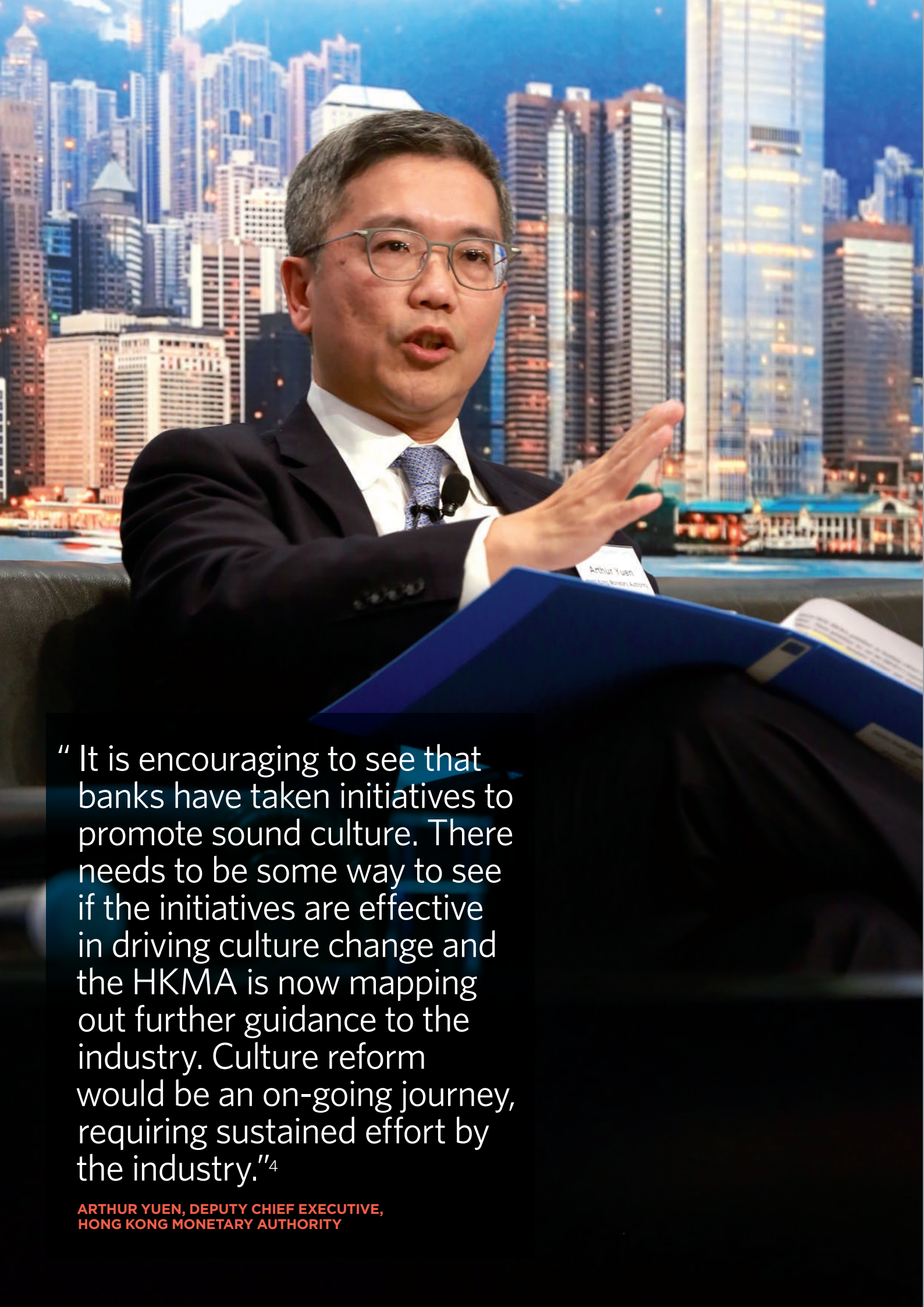
It identifies 21 key cultural drivers of misconduct, which it suggests that senior management should consider to determine whether they are displayed in their organisation.

These drivers include a lack of accountability for misconduct, a mismatch between leaders' words and actions, as well as a 'tone from the middle' which is inconsistent with the 'tone from the top'.

Other drivers include a lack of challenge and debate, decision-making dominated by business lines, and a lack of diversity and inclusion leading to 'group think'.

Also listed are a lack of psychological safety within the firm, a reluctance to accept bad news, a lack of transparency upwards, and the normalisation of misconduct.

1. The Financial Stability Board, "Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors", published 20 April 2018, http://www.fsb.org/wp-content/uploads/P200418.pdf
2. Speech by U.S. Deputy Attorney General Rod J. Rosenstein, "Keynote Address on Corporate Enforcement Policy", given at the New York University Program on Corporate Compliance and Enforcement, on October 6, 2017. https://wp.nyu.edu/compliance_enforcement/2017/10/06/nyu-program-on-corporate-compliance-enforcement-keynote-address-october-6-2017/
3. Speech by Mark Steward, Director of Enforcement and Market Oversight, FCA, "The expanding scope of individual accountability for corporate misconduct", given at the New York University Program on Corporate Compliance and Enforcement, March 31, 2017, https:// www.fca.org.uk/news/speeches/expanding-scope-individual-accountability-corporate-misconduct



" It is encouraging to see that banks have taken initiatives to promote sound culture. There needs to be some way to see if the initiatives are effective in driving culture change and the HKMA is now mapping out further guidance to the industry. Culture reform would be an on-going journey, requiring sustained effort by the industry."[4]

ARTHUR YUEN, DEPUTY CHIEF EXECUTIVE, HONG KONG MONETARY AUTHORITY

Spotlight on Australia

Regulatory focus on culture

In Australia, there has been significant recent emphasis on many of the cultural drivers being highlighted by the FSB. This has played out in the context of:

- an ongoing Royal Commission into misconduct in the banking, superannuation and financial services industry;
- the introduction of BEAR (for which a key stated objective is to improve the operating culture of affected organisations and which introduces a range of obligations to which substantial civil penalties attach);
- a prudential inquiry report published in April 2018 by Australian Prudential Regulation Authority (APRA), which focuses on governance, culture and accountability concerns; and
- various high profile regulatory investigations and enforcement proceedings against financial institutions.

These have shone a spotlight on the importance of fostering a robust culture, overseen at board and senior executive level, which pays proper regard to both financial and non-financial matters, ensures clear escalation and ventilation of risks, facilitates testing and challenge and shifts the focus of decision-making away from a reliance on strict legal entitlements and towards a more holistic assessment of appropriate conduct (reflective of current public sentiment). This emphasis is likely to continue for the foreseeable future.

Spotlight on Singapore

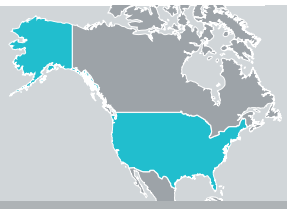
Regulatory responses to rolling bad apples

MAS has recently proposed going one step further than the FSB toolkit, and is seeking to standardise industry practices on rolling bad apples by requiring financial institutions to carry out and respond to reference checks on individuals.

MAS has also proposed mandating the form of employee reference to be provided, and has suggested that any reference should include details of past or present investigations into the individual and the outcomes of these investigations.

The MAS proposal is similar in concept to the UK's regulatory references scheme. However, it is likely to be particularly controversial given a recent Singapore Court of Appeal decision awarding a former employee SG$4m, after finding that a company had breached the duty of care it owed to former employees when providing a reference. This decision followed a well-established line of English case law to the effect that employers must exercise reasonable care when providing references for former employees, and in particular must ensure that the reference does not create a false or misleading impression of the employee.

Spotlight on US



Self-regulatory initiatives as a way to stop the roll

The US Financial Industry Regulatory Authority (FINRA) is a self regulatory organisation which operates the BrokerCheck database. That database includes records of all employment history, customer complaints and firm disciplinary events for brokers and some investment advisers. The database is available to employers for their review in making hiring decisions.

However, a 2017 study indicates that over a third of advisers with a misconduct history are repeat offenders, and that 44% of those terminated for misconduct end up employed as an adviser again within a year. What's more, relative to other advisers who left the same firm at the same time, advisers who engaged in misconduct are hired by firms that employ a greater percentage of other advisers with past misconduct records. In other words, after losing their job following misconduct, advisers tend to end up at firms which are less concerned about misconduct. This raises questions about the extent to which disclosure of misconduct to future employers will actually stop the roll of bad apples.

4. Source: Fireside Chat at the Wealth Management Summit of the Private Wealth Management Association on 28 September 2018

The role of the FSB

The FSB promotes international financial stability; it does so by coordinating national financial authorities and international standard-setting bodies as they work towards developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.

The FSB, working through its members, seeks to strengthen financial systems and increase the stability of international financial markets. The policies developed in the pursuit of this agenda are implemented by jurisdictions and national authorities.

The FSB includes 24 member countries – the United Kingdom, Germany, France, Spain, the United States, Canada, Russia, Mexico, Indonesia, Italy, Japan, Brazil, China, Argentina, Australia, Hong Kong, India, Netherlands, Saudi Arabia, Singapore , South Africa, South Korea, Switzerland and Turkey – as well as the following financial institutions – the Bank for International Settlements, the European Central Bank, the European Commission, the International Monetary Fund, the Organisation for Economic Co-operation and Development, and the World Bank.

But perhaps the most interesting cultural driver identified by the FSB is that of having a mindset or ambition that does not take account of all relevant stakeholders, including customers, markets and society. Whilst we are used to seeing regulators hold firms to account vis-à-vis their impact on markets and customers, the reference to society more broadly is potentially a game changer.

In the context of these and the other drivers identified, the potentially Sisyphean task that the FSB sets for senior management is to articulate a "clear cultural vision" that guides appropriate behaviour within the firm.

The FSB has emphasised that this should be a data and risk-driven cultural vision which specifically addresses the types of misconduct risk already identified by senior management in their organisation.

As part of this task, the FSB envisages that organisations will compile their own additional significant drivers of misconduct, by analysing a broad set of information to identify what drives staff behaviour.

The FSB suggests a broad range of qualitative and quantitative data sources for organisations to consider when assessing the drivers present in their workplace. Some of this data and analysis may already exist – statistics on compliance training, whistleblowers, or performance management issues, for instance.

However, the FSB also suggests other measures and data sources, such as diversity and inclusion statistics, employee engagement surveys, and social media monitoring, to gauge a firm's true culture properly.

The final, and perhaps most important, tool suggested by the FSB is for firms to take action to shift behavioural norms once this 'psychoanalysis' is complete.

This could include formal measures, such as reworking compensation and incentives, and informal measures, such as engagement with staff to improve psychological safety and increase employee willingness to call out misconduct.

Stopping a bad apple spoiling the barrel

The question of how to deal with the issue of repeat offenders or 'bad apples' migrating from organisation to organisation is a trickier problem for the FSB.

It has suggested tools in this area which rely almost exclusively on better due diligence by the hiring firm.

Importantly, the toolkit stops short of saying that regulators should require organisations to disclose former employees' misconduct to new potential employers. However, some regulators – like the Monetary Authority of Singapore (MAS) – have taken a different view. Where regulators have chosen to require this sort of disclosure, financial institutions will need to balance their regulatory obligations against the considerable employment law issues that can arise in many jurisdictions over the disclosure of this sort of information by a previous employer, particularly where the exit was a negotiated one which imposed confidentiality obligations.

Both the toolkit's focus on this area and the regulatory reforms being introduced in this space by jurisdictions like Australia and Singapore suggest that we are likely to see regulators place an increasingly intense focus on the work of human resources and employee-relations teams. MAS foreshadowed this shortly after the release of the toolkit, adding human resources to the functions captured by its draft senior manager regime.

The intent of the FSB is to find ways to prevent problems before they escalate to investigation or enforcement, through assessing firm culture and driving organisational change.

However, increased self-regulatory efforts in this space are also likely to increase the focus on the role of human resources in reducing misconduct. In Australia, for example, a new background check protocol was implemented in late 2017 by the Australian banking industry to give banks greater access to information on prospective employees. However, as seen from US experiences with the BrokerCheck databases, there are likely to be limits to the effectiveness of self-regulatory initiatives or initiatives reliant on disclosure as a method of stopping the roll of bad apples.

Embedding culture across an organisation – where do you start?

For many compliance and legal teams, the breadth of tools proposed by the FSB may be bewildering. That is because the toolkit outlines a more holistic approach to misconduct than the adversarial model of enforcement and fines to which the industry has become accustomed.

Many tools will require sophisticated partnerships with other business lines, such as human resources and strategy, and require frontline business heads to endorse new styles and structures.

For some organisations, these approaches may not be new – but by default these organisations are the least likely to have cultural problems.

Perhaps those challenged by the implementation of these elements of the toolkit have identified their first indicator of poor culture.

Any change of this type and breadth is difficult to embed, and is likely to require a real investment in time and resources. Regardless, the fact remains that cultural change is cheaper in the long term than enforcement actions that drain investment, management time, reputation, and shareholder returns.

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Fintechs: The golden ticket to innovation?

If the level of capital flowing into the financial technology sector is any indication, the growth in number and size of financial technology start-ups cannot be denied. According to a report by KPMG, global investment in fintech companies reached US$57.9 billion by mid-year of 2018, already exceeding the total investment figures of 2017.

The impact of fintechs so far (predictions versus reality)

Fintechs have traditionally been viewed as a source of disruption to the financial services sector, and to established banking institutions in particular. Disruption occurs when a previously exclusive service becomes broadly available in a more user-friendly manner, and usually at a reduced cost. The technological advancements of the last decade, combined with a change in consumer preferences, sparked a fear that the disruption caused by fintechs could lead to many of the services provided by established banks becoming obsolete.

However, the impact of fintechs on the banking sector has been less disruptive than may have been predicted, for a variety of reasons. Fintechs have generally limited their impact to certain discrete areas of financial services – the market for online or mobile payment solutions is a prime example.

> "NAB Labs innovation hub was created to examine new tech to improve NAB's platforms and services."
>
> **MICHAEL BRIDGEMAN, HEAD OF INNOVATION, STRATEGY & EXPERIMENTS AT NAB LABS**

There is also a general reluctance from consumers, at least in the retail banking space, to move to less established or non-traditional payment methods, such as bitcoin or other cryptocurrencies. In addition, established banking institutions have also been adapting and developing their own new technologies in response to the growth of fintechs.

However, rather than viewing the growth of fintechs solely as a disruption, established banks could see the potential benefit of collaboration with incoming fintechs.

In contrast to other sectors that have been impacted greatly as a result of technological disruption (for example, the music, film and mobile phone industries), the financial services sector can be viewed as a fertile ground for collaboration. These two groups of players, through partnership with each other, can overcome issues which are specific to their circumstances and which would otherwise limit their development.

Fintechs, for example, face increasing scrutiny from financial authorities and are likely to be subject to increased regulation; many fintechs will likely not have the financial or operational resources to comply with increased compliance requirements.

Some financial institutions, on the other hand, may lag behind in realising the value of the financial technologies that are available, and often do not have either the agility or the culture of innovation to harness such new technologies.

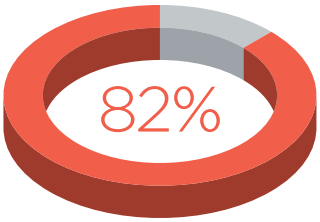
Potential areas for collaboration

Against this backdrop, there has been a developing trend in the financial services market for collaboration and partnership between emerging fintechs and established banks, with 82% of established financial services institutions planning to increase their collaboration with fintech companies over the next three to five years, according to a report by PWC.[1]

GLOBAL INVESTMENT

Global investment in Fintech companies reached US$57.9 billion by mid-year of 2018

INCREASING FINTECH COLLABORATION



82% of established financial services institutions planning to increase their collaboration with fintech companies over the next 3 to 5 years

1. PwC Global Fintech Report 2017: Redrawing the lines – FinTech's growing influence on Financial Services

"Fintechs bring new ideas and a fresh perspective. They help us push the boundaries, which we must do if we are to innovate."

GARY CHU,
EXECUTIVE DIRECTOR AND LEGAL COUNSEL AT UBS IN LONDON

At present, the predominant way in which established banks interact with fintechs is thorough these collaborative partnerships, as opposed to investments.[2]

In particular, established banks are keen to collaborate with the fintechs that offer solutions or propositions that already align with internal innovation strategies or with those that offer expertise in a particular area of innovation.

Partnerships can be highly beneficial for both parties, especially in the current financial market; strategic co-operation between fintechs and established banks can allow each side to offset existing weaknesses, and build upon the other's capabilities.

Many established banks are developing fintech products in-house. For example, the Australian bank Westpac facilitates an 'incubator' through which it supports start-ups. Partnerships with new entrant fintechs provide a cost-effective solution through which banks can benefit from off-the-shelf innovative financial technologies, particularly in the areas of retail banking and payment systems. Fintechs can also allow established banks to access a wider customer base by enabling them to provide financial services in new and emerging markets.

Partnerships with fintechs can also improve customer perception of an established bank, giving it a reputation for active innovation (rather than reactive participation) in providing more user-friendly products and services. According to Gary Chu, Executive Director and Legal Counsel at UBS in London, "Fintechs bring new ideas and a fresh perspective. They help us push the boundaries, which we must do if we are to innovate."

In turn, partnerships can allow fintechs to benefit from the greater levels of funding that will be provided by the partnership bank, potentially accelerating the development of innovative products.

From a legal perspective, partnering generally does not require the same level of regulatory and competition compliance that merging or information sharing between financial services providers is likely to require. Partnering also allows for clearer allocation of intellectual property rights and licences than establishing a new corporate venture.

However, partnering is not without its risks, and reliance on third parties can prove difficult. For example, partnering can create issues in data sharing due to privacy laws, and in particular consent requirements.

There are several areas in which collaboration between fintechs and established banks could prove highly effective:

Integration of payment solutions into social media platforms

Social media platforms are utilising new financial technologies to integrate payment and lending solutions onto their platforms. For example, Japan's Line Corp added financial services to its offerings with the establishment of its wallet service 'Line Pay', which has over 40 million users registered to the platform.

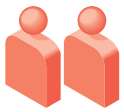
However, there are opportunities for collaboration between social media platforms and existing banking institutions. Social media platforms can enable banks to develop new services which can be accessed conveniently on these online platforms. In 2016, American Express developed an in-house automated computer program 'chat bot', which could be enabled on Facebook Messenger. The bot allowed American Express to interact with its cardholders and send purchase notifications, and could also be used to store card information and make purchases.

Mobile payment solutions for emerging markets

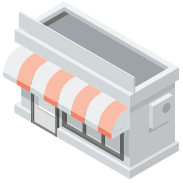
In 2016, it was estimated that two billion individuals and 200 million micro-medium size businesses in emerging economies did not have access to savings and credit accounts.[3] Emerging markets, which may not benefit from established banking institutions and financial regulations, have therefore opened up a wealth of opportunities for fintechs, as digital finance provides an alternative solution to the traditional banking system.

Collaboration between new financial technologies and established banks could allow banks to access the non-banking population in emerging markets (e.g. in India, where the number of users with access to online payment options is predicted to reach 800 million users by 2019, in comparison to the 400 million users in 2014)[4], whilst saving costs by shifting from offering traditional accounts to digital accounts, which can be 80-90% less expensive to service[3].

NO ACCESS TO SAVINGS AND CREDIT ACCOUNTS



2 billion
individuals



200 million
micro-medium businesses

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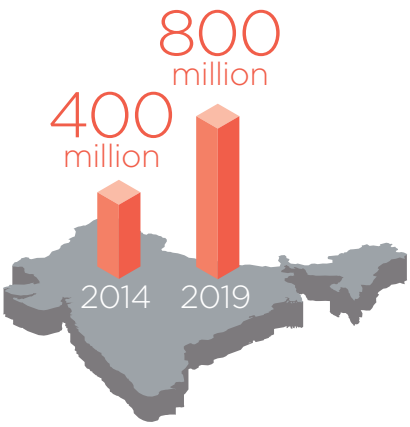
USERS IN INDIA WITH ACCESS TO ONLINE PAYMENT OPTIONS



The number of users with access to online payment options in India is predicted to reach 800 million users by 2019, in comparison to the 400 million users in 2014.

2. European Banking Authority Report on the Impact of Fintech on Incumbent Credit Institutions' Business Models, 03 July 2018, page 25
3. McKinsey & Company – FinTechnicolor: The New Picture in Finance, February 2016, page 26
4. PwC, Emerging Markets: Driving the payments transformation

Growth of 'RegTech'

Of particular interest to established banks could be the growth in regulatory technology, or 'RegTech', which aims to provide technologically advanced solutions for financial services firms, in light of the growing demands of compliance with financial regulations. RegTech companies seek to use data analytics and artificial intelligence to assist banks in predicting compliance risk, and automate processes such as AML and KYC checks.

Case study: Core banking platforms

Core banking systems are at the heart of the operations of many banks. However, many of these legacy systems are often too complex and working way beyond the capacity they were originally designed to support. One of the applications of blockchain technology to the banking sector, and a potentially rich source of collaboration between fintechs and established banks, is the use of such technology to transform or replace existing core banking platforms.

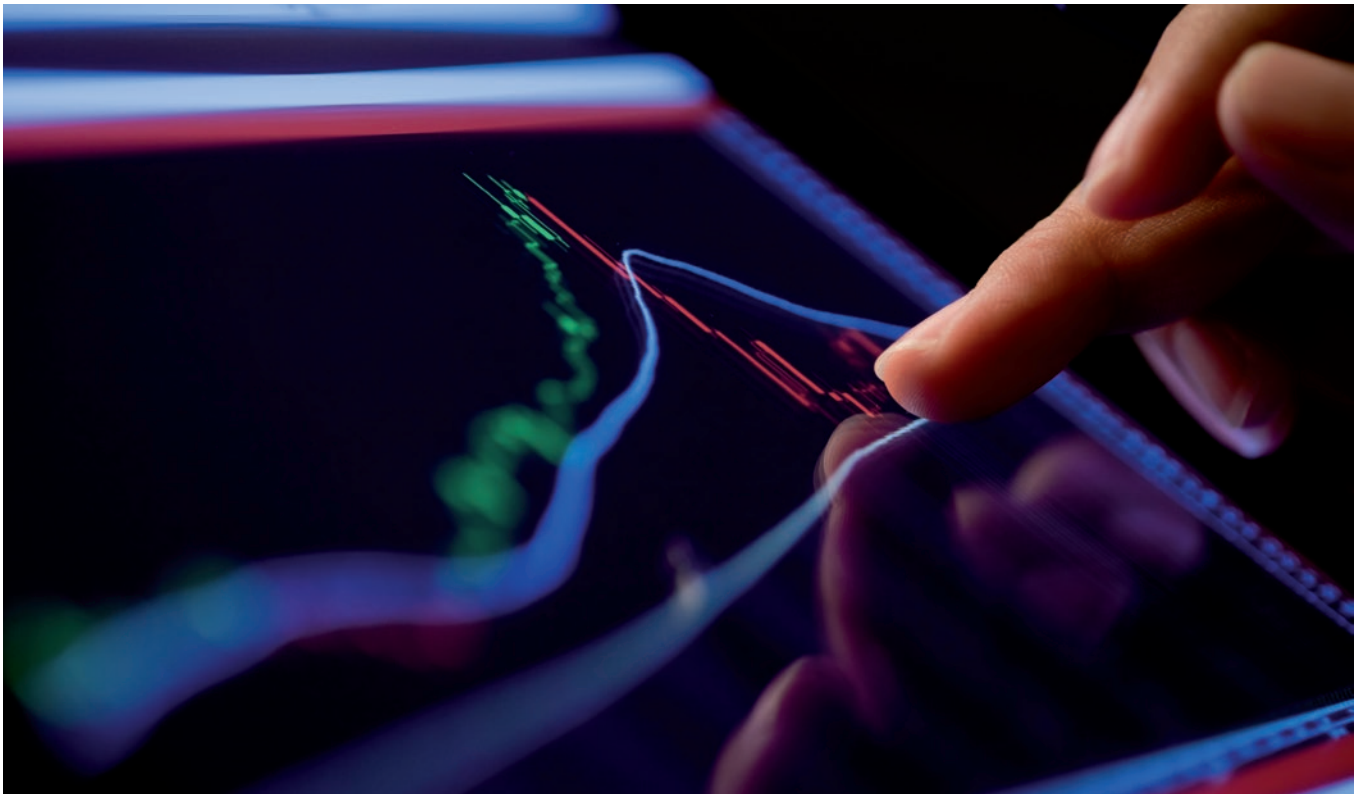
Potential challenges to collaboration

Fintechs still have potential to disrupt areas of the financial services market. Disruption is rife in the payments landscape, as payments have continued to migrate to digital channels due to the dominance of online sales and increasing mobile connectivity. Recently, US-based payment processing and technology provider Vantiv acquired UK-based WorldPay for US$12.9 billion, creating a leading payments provider capable of processing more than 40 billion transactions annually. However, there are additional challenges to the potential partnerships between fintechs and established banks.

From a risk perspective, established banks may be wary of negotiating service contracts with fintechs which are currently not subject to the same financial regulations as they are. Established banks may struggle to ensure that service contracts impose appropriate reporting and compliance obligations on the fintech company to ensure that they are not in breach of their own obligations as a regulated financial institution.

> "The extent of [financial institutions'] reliance on third parties results in emerging new business models that in turn create systemic risks (rather than the traditional material outsourcing risk)."
>
> **AGNIESKA VERLET, SENIOR LEGAL COUNSEL AT SC VENTURES**

It is also worth noting that the issue of varying financial regulation may also allow the encroachment into financial services by Big Tech groups. The introduction of 'open banking' regulation in 2018, which forces lenders to provide access to their customer accounts where authorised, could allow Big Tech companies to increase their activities in the financial services sector. In contrast to many fintechs, Big Tech groups have both the financial and technological resources to challenge traditional banks. In recent years, companies like Amazon have started to provide payment services and loans to merchants on its platform, while Alibaba and Tencent have dominated the payments industry in China.



In Europe, certain financial technologies now hold a higher risk profile in light of the General Data Protection Regulation (2016/679) (GDPR). Many fintechs use big data analytics or machine-learning techniques to automate the credit decision process for established banks, and may face challenges in complying with the GDPR in their processing of large quantities of personal data. In such cases, established banks (who have provided the personal data of customers for processing) may also find themselves liable for any breaches of the GDPR that arise, which could entail both large financial penalties and reputational damage.

However, established banks can take comfort from the fact that some regulators are becoming more open to the use of innovative technologies. For example, in Europe, the regulatory obligations for cloud outsourcing are currently undergoing review. In late June 2018, the European Banking Authority issued draft guidelines on outsourcing arrangements for consultation. These guidelines aim to clarify uncertainty regarding supervisory expectations for institutions using cloud services.

The guidelines provide a clear definition of outsourcing, and set out the responsibilities of institutions' management bodies for the establishment of an appropriate framework for outsourcing that will cover the entire process, from undertaking due diligence to exit. The guidelines require institutions to ensure that there is a comprehensive outsourcing policy and outsourcing process, and that there are appropriate plans in place for the exit of critical or important outsourcing arrangements.

> From a risk perspective, established banks may be wary of negotiating service contracts with fintechs which are currently not subject to the same financial regulations as they are.

According to the EU Commission's March 2018 FinTech Action Plan, European supervisory authorities will prepare formal guidelines on cloud outsourcing by the first quarter of 2019. The Commission is keen to ensure that obstacles to cloud services are reduced, including the uncertainty arising from the absence of harmonisation of national rules and differences in the interpretation of outsourcing rules.

In Hong Kong, the Hong Kong Monetary Authority (HKMA) is poised to issue virtual banking licences to promote fintech to offer customers a varied retail experience. Virtual banks will not need to maintain any bricks-and-mortar presence, although they do have the option of having customer service centres. They can provide loans, and operate savings accounts with no minimum account balance or low-balance fees. They can also issue credit cards, or offer online payment services.

The HKMA said as of 31 August that they had received 29 applications for the first batch of virtual bank licences, with the applicants ranging from telecommunications operators and financial technology companies to global banks. The new virtual banks are expected to pave the way for more products and choice to help young companies and consumers, and foster a more innovative environment.

More robo-advisors in Asia are also partnering up with banks to offer investors the opportunity to invest in diversified portfolios of stocks and exchange traded funds, using automated, algorithm-based portfolio management advice. An example is OCBC Bank, which has partnered with WeInvest, a Singapore-based fintech firm, to offer clients this service to democratise wealth management by making it more simple and accessible for investors.

VIRTUAL BANK LICENCES

29 applications

As of 31 August 2018, the HKMA had received 29 applications for virtual bank licences, with applicants ranging from telecommunications operators and financial technology companies to global banks

Conclusion

Although the impact of fintechs on the financial services industry may not have been as monumental as once predicted, fintechs continue to disrupt and grow in strength and number. They assist in the creation of efficiencies and enhancements of consumer experience.

Nonetheless, established banks are increasingly looking to nurture innovative ideas using a variety of means. These include using skilled in-house development teams to develop disruptive technologies from within.

Despite the regulatory hurdles, collaboration between emerging fintechs and established banks can still be viewed as a relatively quick route to successful innovation. Whether fintechs are the golden ticket remains to be seen.

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The Global Financial Crisis 10 years on

Ten years after the global financial crisis (GFC), we look back on how the banking sector has been impacted. As well as key lessons, we delve into the risks that remain relevant for banks and financial institutions today.

The Global Banking Review asked four senior financial services figures who lived through the thick of the GFC to reflect on their experience of it, and the ten years since, and to provide their insight on the challenges to come.

Contributors interviewed by Harry Edwards, Partner at Herbert Smith Freehills, London.

Ruwan Weerasekera (RW) is the Senior Independent Director of ICBC Standard Bank Plc, Chair of its Remuneration Committee and a member of their Risk and Audit Committees. From 2005 to 2015, Ruwan was at a global investment bank and played a key role in navigating the bank's response to the financial crisis as Chief Operating Officer for Securities.

Avinash Persaud (AP) is a financial and economic policy advisor to large financial institutions and G20 Governments. Following the financial crisis, he was appointed by HM Treasury as an Expert Member of its Audit & Risk Committee, with a focus on the oversight of the UK Government's stakes in the financial sector during the financial crisis. From 2009 to 2010 he was appointed as the UN Commissioner on Financial Reform.

Paul Sharma (PS) was formerly Deputy Head of the UK's Prudential Regulation Authority and an Executive Director of the Bank of England, and has over 20 years of experience as a top UK, EU and global financial services regulator. He is now a Managing Director with Alvarez & Marsal and co-head of the firm's Financial Industry Regulatory Advisory Services practice in London.

John Williams (JW) was a Partner at the boutique corporate advisory firm, Gleacher Shacklock, and responsible for its Financial Institutions Group during the financial crisis. He has had over 30 years of experience in investment banking and corporate advisory, including senior roles at Lehman Brothers, JP Morgan and Kleinwort Benson.

Harry Edwards (HE): Looking back, what was your personal experience of the GFC? Can you recall your immediate thoughts as the events unfolded?

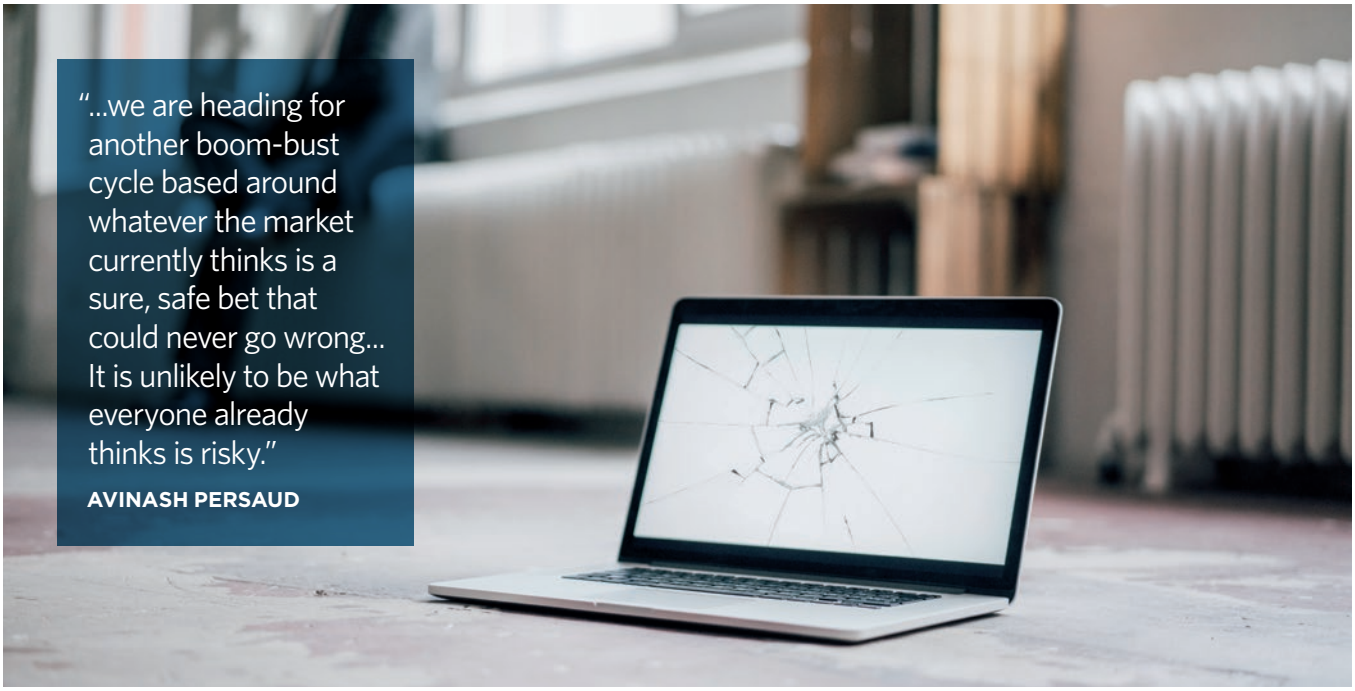
RW: At the time I was the Chief Operating Officer of the Equities business and I remember vividly, at the start of the credit crunch in July 2007, how we took the top 100 people in the business away for three days of strategy discussions, team building and goal setting for the remainder of the year. At that time we were setting our target for a US$10 billion year for our business which felt in our grasp as the biggest equities business on the Street.

The first time I realised the severity of what we were seeing was a few days later when the head of fixed income and credit came to our equities management meeting to talk through what was happening and I clearly remember him saying that these were some of the most dangerous markets he had ever seen in his career. Everyone in senior management at every bank had been through the 90s recession, the Russian crisis in '98 and the dot com boom and bust. No one, at the time, expected to go through the 10 years we have been through.

No one forgets the immediate aftermath of the collapse of Lehman Brothers, of course. I remember our own capital crisis, the step in of government and saviour shareholders, our deferred stock heading sharply downwards to never recover and also the revolving door of management as we had rapidly turning over C-suite roles. Just down from those levels it was then up to some to run towards the problem and remediate and survive alongside the rapid scaling back of the business we had to do across the whole organisation. Decisions around downsizing were obviously very difficult.

AP: The GFC began for me 10 years previously. In July 1997 I was sitting on the Singapore dealing floor of the large bank that I worked for, watching the Asian crisis unfurl. What caught my eye was how our state-of-the-art risk management system seemed to be adding to the risk. A couple of years earlier we had successfully persuaded the regulators that our new risk-sensitive system was so safe that they should discount the amount of capital we should hold. They agreed and decided that every bank should have a similar system. In July 1997, as market volatility rose, the risk system told us to sell financial instruments to reduce our risk exposure. But our selling was pushing volatility and correlation up which in turn caused the risk system to tell us to sell more. It was my introduction to fallacy of compositions: what may appear as the right action from an individual perspective could be the wrong action when everyone is doing it. Fallacies of composition lay at the heart of the GFC.

Following my observations on the Singapore dealing floor I wrote an essay called "Sending the herd off the cliff edge: how modern risk management systems create risks" about the perils of modern banking regulation. It won first prize in the Jacques de Larosière Award in Global Finance which brought me to the attention of policymakers who liked the mix of philosophy and practice. The Golden Hall of the Banque de France is



one of the most amazing places to give an after-dinner speech, and it is up against a few palaces. But at the end of the evening, central bankers would pull me aside and say that while they liked the idea, it was far too pessimistic. I have a letter from a former US Treasury Secretary saying just that. I persevered for a bit, developing the ideas in different directions. I pointed out that financial crashes only occur after booms and that in a boom, the market is convinced that everything is safe, so market-driven risk management systems, favoured at the time, would drive banks to double up on risks at the top of the boom and double down on safety at the bottom of the bust. It was dangerously pro-cyclical.

When the crisis hit, these same central bankers were quick to realise their mistake and I was part of the policy efforts to work out how to fix the mess and develop new macro-prudential rules to offset pro-cyclicality. There was a small group of us 'macro-prudentials': Claudio Borio, Hyun Shin, Charles Goodhart, John Eatwell, Stephany Griffth-Jones and myself. We became serial members of committees, commissions and task forces across the world.

PS: In retrospect, I see the onset of the GFC as 9 August 2007 when mid-sized UK banks first experienced difficulties obtaining liquidity from the wholesale and inter-bank markets. I was then at the Financial Services Authority. I was head of its specialist Risk Review Department which comprised its deep experts especially in quantitative techniques of risk management.

From that day onwards I, and the specialists I led, were kept very busy starting with a couple of visits to Newcastle in late August 2007, then to Bradford, Leicester and other provincial towns! At this point the crisis was to me very much a secondary banking crisis, which I saw as systemic but not fundamental. We referred to it as a 'credit crunch' and saw it very much as a sub-prime crisis with primarily a US origin.

That all changed over a weekend in March when I found myself sitting across the table opposite senior executives from Bear Stearns. Although with its takeover by JP Morgan, Bear Stearns survived the weekend, from that point on it was clear that the crisis posed a threat to financial capitalism globally that was unprecedented since the 1930s. That threat crystallised with the failure of Lehman Brothers in September the same year. Again, the events unfolded over a weekend, and I found myself negotiating technical details with respect to abortive efforts to rescue Lehman Brothers. Several further frantic weekends followed including in mid-October with the recapitalisation of the major British banks.

JW As I recall, there were a few things that struck me at the time. Most practitioners across the market were surprised by the speed at which the crisis spread, particularly among the larger banking institutions. There had been some indications of strategic and financial difficulties among UK banks in the period leading up to the crisis, for example with the converted building societies (Abbey National, Halifax, Bradford and Bingley, Alliance & Leicester and Northern Rock), but it was not until Autumn 2008 that the crisis took hold in earnest. I think the speed and severity at which funding difficulties then impacted large British banks, the principal US banks and insurers, the Irish banks and, perhaps less surprisingly, the Icelandic banks, was a striking feature of the crisis. Even the building societies whose balance sheets were thought to be relatively simple in their liability and asset structures were affected. The FSA encouraged a number of mergers, particularly into Nationwide, of societies who had begun more risky forms of lending and funding. Anecdotally, I remember visiting the CEO of a society whose balance sheet had become relatively exposed to the crisis. He had cleared his desk, put his

"...what may appear as the right action from an individual perspective could be the wrong action when everyone is doing it. Fallacies of composition lay at the heart of the GFC."

AVINASH PERSAUD

"...from that point on it was clear that the crisis posed a threat to financial capitalism globally that was unprecedented since the 1930s."

PAUL SHARMA

telephone in the middle of it, was doing no work and said he was simply waiting for the call from the FSA about a merger partner and for the sack.

I also remember noting how quickly and deeply the financial crisis fed into the real economy. The period leading to the crisis had been particularly active for private equity companies in acquiring large household brands and particularly high street retailers. Private equity and hedge funds rapidly became unable to refinance themselves following the crisis leading to a series of high profile liquidations. For the man in the street, the crisis was not just some form of financial disruption but was having significant and severe effects deep into the real economy.

There were, I think, contrasting reactions between different generations of investment bankers. There was a deeper sense of anxiety and pessimism among more junior bankers than more senior, experienced bankers whose careers had spanned several previous but less severe market crashes. Their more sanguine approach brought a measured and constructive counter-balance in the advice being given to clients.

Another strong impression at the time was the determined opposition held by bank boards to the prospect of any form of state ownership as part of a recapitalisation or financial solution. I remember a board member of a retail bank telling me that having the Government on the share register would be worse than prison.

HE: How real did the threat to the existence of specific financial institutions and the wider financial system feel at the time?

RW: The threat to the financial system appeared remote at first but rapidly increased. It gathered pace with the realisation as to the scale of losses versus the level of capital held to absorb these losses and, in particular, the unhedged and unknown nature of some of the risks. We didn't know how this would play out but if you were in the room at the time you had to assume that the worst case scenario could happen and work out how we were going to survive.

Looking back at it now, for many of us the crisis and the response to it was, strangely, the making of our careers as we had to perform in circumstances that there was no playbook for. It was not about financial reward but was about survival and remediation. It was both terrifying and exhilarating and I am proud of the organisation I was part of and its people for the way we responded.

AP: Years before the GFC, I had argued that banks don't go bust because what they knew was risky was indeed risky, but because what they thought was safe turned out to be hazardous. Under the risk-sensitive capital regime for banks, what was safe did not require capital to safeguard against something going wrong. Consequently, banks that looked super safe in 2006 were dead in the water in 2008. The system was bust. Banks were falling like flies with failure begetting failure. It was a crazy time, and policymakers were demanding the policy advisors fill the void. Policies that we had flogged for decades to deal with pro-cyclicality were being taken up in minutes.

JW: Very real. I recall the tensions between members of the Tripartite and particularly between the Treasury and the Bank of England in how to deal with the crisis they faced. Leadership within the Tripartite did not always seem to be clear and responsibilities were sometimes opaque. The regulators were scrambling around in an effort "to catch a falling knife" to quote a favourite expression among investment bankers at the time.

PS: The GFC taught us that no bank was so safe or stable that its risk of failure was beyond contemplation. It also taught us that there were banks which were too large, too complex and too interconnected with the rest of the financial system, to be allowed to fail.

HE: How is the awareness of systemic risks different today compared to 10 years ago?

RW: I find it interesting that the cultural and behavioural issues that were one of the root causes of the financial crisis were also the same issues contributing to the conduct incidents that have occurred in the City since the crisis. It is an open question as to whether the culture within banks has changed enough in the last 10 years, and I think it is the role of all stakeholders - shareholders, clients, customers and suppliers, as well as the staff - to continue to address this.

I think that the awareness of systemic risks, which I now see from the viewpoint as a Senior Manager (under the Senior Managers and Certification Regime) and as a Senior Independent Director at ICBC Standard Bank, has now hugely evolved. The understanding of scenario risks and modelling, value at risk, liquidity and capital adequacy are substantially more sophisticated and rigorous - but of course they are untested this time around. There is comfort in the attention paid to these issues and the increased level of capital. I think that leadership style and qualities are now different and this permeates the culture through the top down nature of modelling and the way banks and regulators now work.

It is not all plain sailing though. I continually worry that we have focussed on solving yesterday's problem really well, without a real sense of the resilience required for tomorrow's crisis which will surely come. I worry about whether all the on-the-surface attention to values and behaviours and culture are sufficiently moving the needle everywhere; the links across the industry remain substantial. I wonder whether at the critical point of supervision - which is always around desk head level - things have changed enough. We have many more traps, catches, surveillance approaches and taxonomies. Is that enough? Levels of compensation in the City are at the same level. Have compensation practices really changed enough? Sometimes it feels only that there is more fixed and less variables, but total compensation remains the same.

PS: Today these lessons are at the forefront of everyone's mind. In the aftermath of the GFC I co-chaired the Macro-Prudential Group of the Basel Committee, which together with the Financial Stability Board chaired by Governor Carney, led the international work to create new technical tools to address these problems.

The systemic risk of banks is vastly better understood today than it was 10 years ago, and much better technical tools are now available to monitor and manage that risk. But this new understanding might at best be of only fleeting relevance. Step forward another 10 years and I expect banks to be either transformed, or perhaps disintermediated and reduced to irrelevance, by new technology. We see the first steps today with the rise of new fintech firms challenging banks, for example, in payment services and in peer-to-peer lending.

JW: As Paul mentioned, the GFC and the increased regulation brought about a growth in financial disruptors, such as peer-to-peer lenders, fintech companies, challenger banks and traders in cryptocurrencies. The weight of regulation and the caution of big bank boards against the more risky financial and funding products has in part promoted the growth of the disruptors. It is an example of creative destruction and is enhancing the range of financial products available to consumers and the methods of sourcing them. Equally, it is encouraging consumers into the more lightly regulated and arguably less well understood parts of the financial services sector. These possibly unintended consequences may not lead to the outcomes which policymakers and regulators had as objectives immediately following the crisis.

HE: Finally, will the lessons from ten years ago be remembered?

RW: Will we remember 10 years from now? Yes. There are too many books and films, and too much pain, to forget. However, I do worry that 10 years from now, everyone who ran towards the problem and stood up and led and survived will be long gone. How can we sufficiently use the culture of our firms to really think of leadership as stewards for each generation? And pass on what we know and what we fear and what we can do? That is a driving question for all of us who are involved in the markets.

> "It is an open question as to whether the culture within banks has changed enough in the last 10 years, and I think it is the role of all stakeholders - shareholders, clients, customers and suppliers as well as the staff to continue to address this."
>
> **RUWAN WEERASEKERA**

AP: The speed with which our macro-prudential ideas were taken up was exciting, but as time has worn on, the 'macro-prudentials' have seen their pride in making a little difference fade a little. We have come to see that many policymakers adopted the ideas before they fully understood or bought into them. Instead of macro-prudential meaning a countervailing force to the cycle of market optimism, it has become an excuse for merely taking a broader perspective of risks beyond small measures of volatility and correlation. The problem with that is that this broader perspective is also going to be pro-cyclical. The broader perspective looks rosy at the top of the boom and dreadful at the bottom. So, I feel the lessons from 10 years ago have not been learned, and we are heading for

another boom-bust cycle based around whatever the market currently thinks is a sure, safe bet that could never go wrong: perhaps that's social media, technology or renewable energies. It is unlikely to be what everyone already thinks is risky.

JW: One of the regulatory objectives during and following the crisis was to ensure that the orderly failure of firms was possible, to avoid firms becoming "too big to fail". I am not certain that this policy objective has been achieved or could be achieved or is viewed with any credibility. My view is that the financial services sector will and should always be treated differently, especially as financial products begin to return to their previous complexity. Most consumers of financial services lack the experience and knowledge to reach an informed decision about the financial integrity and risk profiles of competing banks (relevant to a purchaser of financial services products but not to a purchaser, for example, of a microwave oven). The evidence is that consumers retain long term loyalty to their financial services provider irrespective of changes in the financial condition and prospects of those institutions.

I would also add that since the GFC, the relationships between regulators and the regulated has changed. My sense was that in the approach to the crisis these relationships were typically antagonistic and characterised by point scoring and press leaks. Perhaps the leak of Northern Rock's financial difficulties is a good example. My impression now is that these working relationships have become more constructive and closer, perhaps because of a greater professionalism on both sides as a result of the crisis. However, the regulatory process for approving the appointment of non-executive directors to bank boards and the continuing obligations which apply to them is now so protracted and detailed that several of my former colleagues and clients have decided that the rewards do not justify the risks. An experienced former retail banking executive recently told me that the regulatory regime for approving the appointment of non-executives and the regulatory scrutiny which then attaches to them has become a triumph of form over substance and talent is being lost as a result.

PS: This is the most difficult question to answer. I do not expect the next global financial crisis to be similar in detail to the 2008 GFC, but I do expect it to be within my lifetime and no less serious than the 2008 GFC. The narrow technical lessons have been learned; for example, banks hold vastly more capital today, and further they are to hold a new form of loss-absorbing (so-called 'bail-in') debt. That might help in pre-packaging who first is to bear the losses when the next crisis occurs, but it will achieve little beyond that. The basic problems remain. A credit crisis occurs because during the good times too much credit is given to consumers and firms go well beyond their ability to repay, and a global credit crisis occurs because globalisation aligns the timing across different geographies of these boom-bust credit cycles. This problem has not been solved.

HE: Thank you very much.

"The GFC and the increased regulation brought about a growth in financial disruptors, such as peer-to-peer lenders, FinTech companies, challenger banks and traders in cryptocurrencies."

JOHN WILLIAMS

Under the competition law spotlight: What financial services firms need to do to protect themselves

Competition law regulators tend to move as a pack. They communicate with each other through a number of official and unofficial channels. When one regulator begins to focus on a particular industry or sector others are bound to follow.

Increasingly, financial services is an area of worldwide competition law focus. Generalist competition law agencies are upskilling staff and becoming more literate about financial products and services. The scope of investigations are expanding beyond 'chat room' trading conversations. Activities which might be considered as business as usual and competitively benign or even pro-competitive are being considered anew by competition regulators.

In a world of increasing regulatory scrutiny, increasing penalties and the possibility of criminal sanction in various jurisdictions, it is important to get ahead of the regulator and actively manage competition law risk. Conduct which, on its face, would appear to involve legitimate collaboration between service providers, may be seen as something else entirely by the competition law regulator.

> The ACCC has noted "these important amendments are likely to significantly improve our capacity to tackle anti-competitive conduct in the financial services sector"

What is happening where

The financial services sector has been subject to intense competition law scrutiny across Europe in recent years. The European Commission has issued significant fines in relation to, for example, interest rate manipulation (LIBOR and EURIBOR) to a number of leading financial institutions. Activity is also increasing at the Member State level. The UK Financial Conduct Authority has concurrent powers to enforce competition law in respect of financial services. They have recruited a large team of competition specialists and opened their first cases in the insurance and asset management sectors.

Syndicated lending has become an area of particular scrutiny in Europe. The UK FCA issued 'on-notice' letters to banks suspected of competition law infringements in the context of loan syndication. In addition to this, the Spanish competition authority fined four banks a total of €91 million for price fixing in respect of interest-rate derivatives attached to syndicated loans.

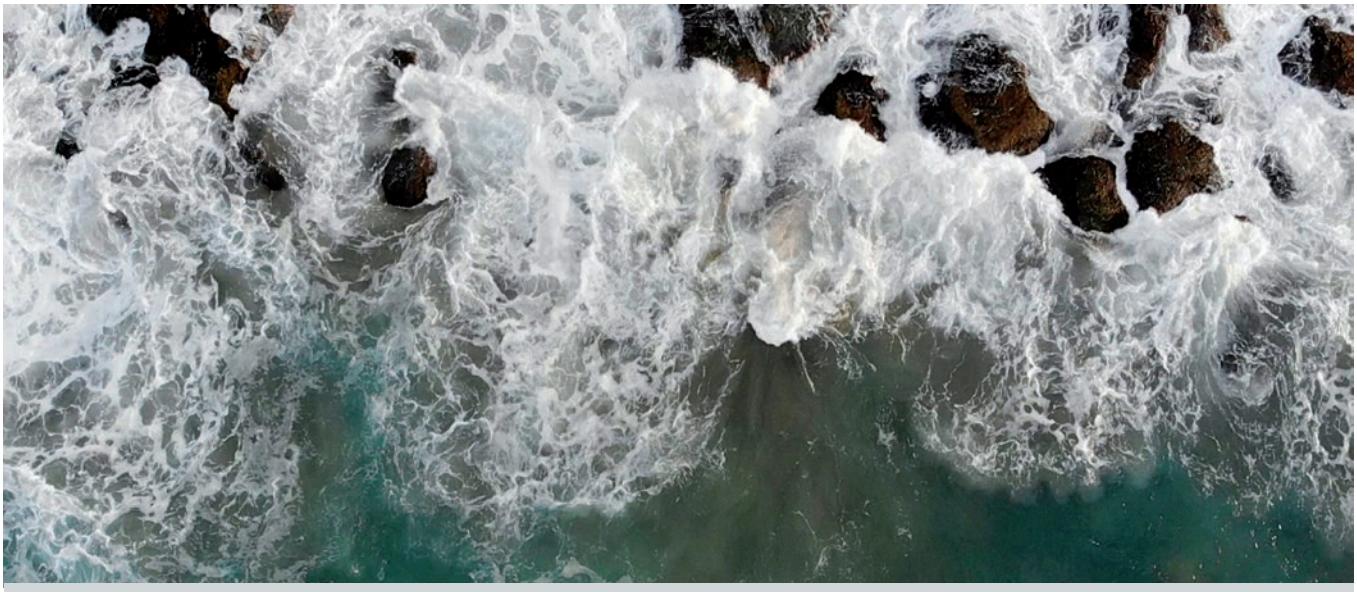
The European Commission has also taken an interest in this topic, commissioning a 'study' to provide an overview of loan syndication in the EU. The study will examine the loan syndication markets in six Member States (France, Germany, the Netherlands, Poland, Spain and the UK). An area of specific focus will be risks at the 'pre-formation stage', where the Commission has requested that the study consider information exchange and the risk of anti-competitive coordination pre-mandate. This study is due to be completed in Q3 2018 and could be a pre-cursor to further action by the Commission in respect of syndicated lending, such as a sector inquiry or targeted enforcement action.

Similarly, in Australia, there has also been a clear focus on the financial services sector. Cartel conduct proceedings have recently been commenced against Deutsche Bank, Citi Bank and ANZ Bank regarding the trading of ANZ shares following an institutional share placement in which Deutsche, Citi and JP Morgan acted as joint underwriters. The decision to commence criminal proceedings (as opposed to civil proceedings) not only against the

FINED FOR PRICE FIXING

€91 million fine

The Spanish competition authority fined four banks a total of €91 million for price fixing in respect of interest-rate derivatives attached to syndicated loans



What do GC's need to do?

In designing an effective compliance approach we recommend that the general counsel office conduct department by department interviews to identify the nature and substance of competitor interaction. Potential questions for business units active in financing could include:

- If discussions are held with competitors for the purposes of arranging financing, what is the context of such discussions?
- Do discussions with competitors take place prior to commencement of a proposed transaction, or are they transaction specific and only take place once a transaction is under way?
- Is the client aware that your business unit is speaking to competitors regarding the deal (eg is the client informed in advance if your business unit is speaking to other lenders in order to pull together a syndicate)? Is the client's consent sought prior to such discussions?
- Outline the process by which transactions are arranged in your business units and syndicates are formed, including the client's role in this process. Are there any relevant process maps which are used or could be developed?

Once an institution has mapped the extent of interactions with competitors, targeted and effective compliance training can be developed to address specific areas of concern or to reassure business units that their current approach is appropriate.

An important area of training is not simply to identify risk but to provide assurances that certain conduct is acceptable.

corporations, but also against individual executives, has gathered significant attention in Australia and elsewhere.

Australian law has recently introduced the European concept of a 'concerted practices' prohibition which seeks to regulate exchanges of information where there is not necessarily a cartel premised on a specific arrangement or understanding. While the prohibition is of general application, the ACCC has noted "these important amendments are likely to significantly improve our capacity to tackle anti-competitive conduct in the financial services sector".

What can you do to protect yourself?

We increasingly see competition law regulators focusing on the examination of conduct in relation to the business-as-usual practices of financial institutions. Doing what you have always done, being confident that you are acting for the benefit of your customer, or seeking to ensure orderly markets may not be a sufficient response to a competition law regulator in this new environment.

It is important that employees, especially those that interact with competitors, understand that their conduct is of interest to regulators and that the regulators may approach business-as-usual conduct with a very different, and arguably jaundiced, perspective. There may be potential concerns even if conduct reflects longstanding practices. The most effective way to identify risk and ensure compliance is through classroom-based training for particular 'at risk' segments within an institution with a focus on scenario learning. Traditional computer-based compliance is unlikely to be sufficient to allow staff to identify matters of concern or provide adequate guidance.

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Australia's Banking Royal Commission: Spotlight on Culture

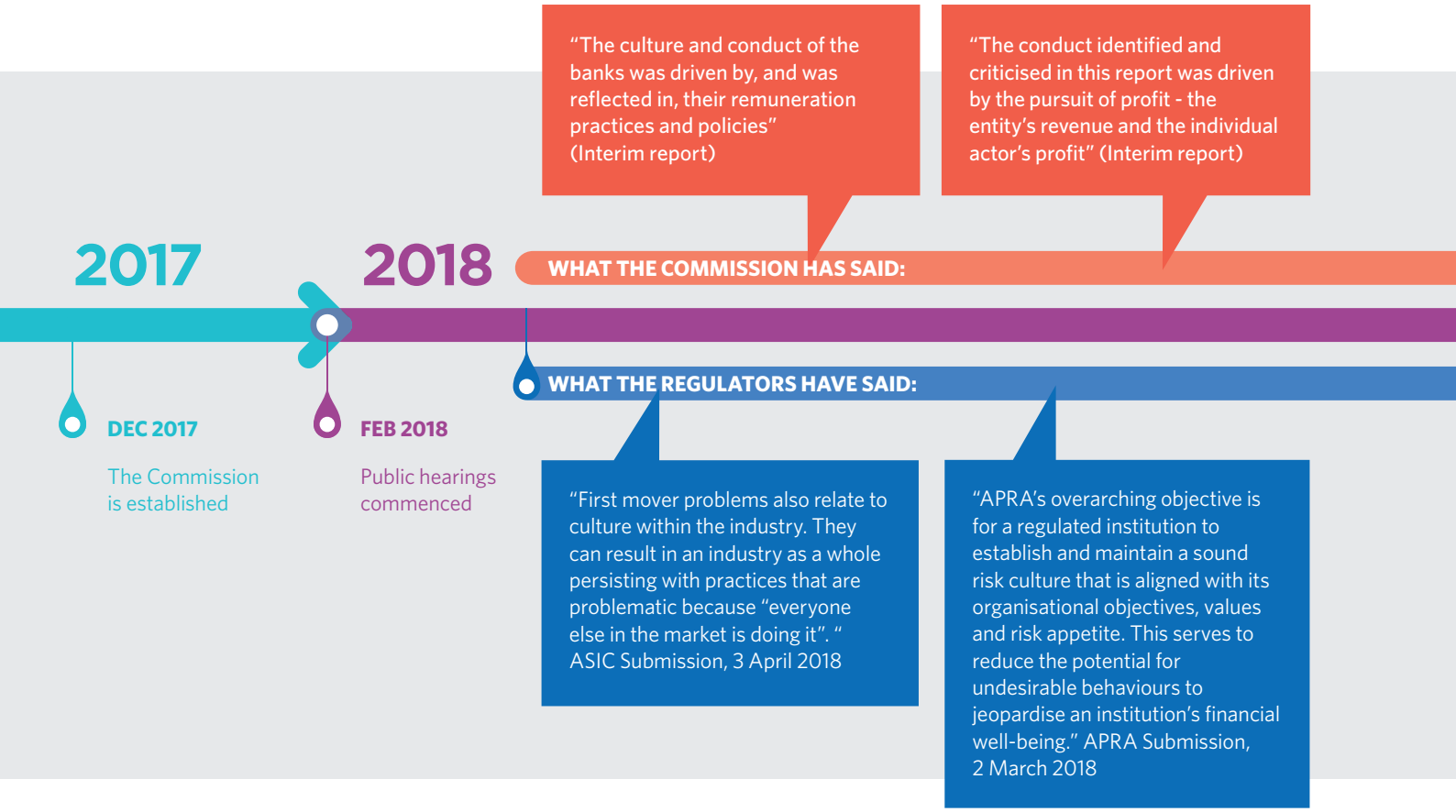
Banking culture and how to regulate it has been a driving theme in Australia's Royal Commission into misconduct in the banking, superannuation and financial services industry.

Australia's Banking Royal Commission (the Commission) was established in December 2017 following lengthy political and community debate, and a litany of previous inquiries and reviews, into regulation of Australia's banking and financial sector. In the three and a half years before the Commission was announced, separate parliamentary, industry and other inquiries had examined aspects of the sector, with questions of culture and governance woven throughout those reviews.

Against that background, the Federal Government appointed former High Court judge Kenneth Hayne to head the Commission, conferring on him the extensive coercive powers of a royal commission to hold hearings, compel witnesses to give evidence and require entities to produce vast amounts of documents and information.

The question of culture is squarely raised in the Commission's broad terms of reference, which include inquiry into whether conduct, practices, behaviour or business activities amount to misconduct or fall below community standard or expectations, and whether those findings are attributable to a particular entity's culture and governance practices or broader cultural or governance practices in the relevant industry or relevant part of the industry.

We set out below some of the key dates, highlights and quotes from the Royal Commission:



A cultural legacy?

Will history judge the Commission as a catalyst for further cultural change in the banking sector?

The very public live web-broadcast of hearings, and close media attention on the Commission process, has undoubtedly made a mark on the industry.

However, as a vehicle to explore complex questions of culture and governance, despite its broad powers, a Commission is in many ways a limited creature. The immediate output of the Commission is to find facts, express opinions and make recommendations. It does not prosecute, it does not regulate, it does not legislate.

And while culture is a permeating theme, it is by no means the sole focus on the Commission's work or its terms of reference. The Commission has prioritised giving voice to consumers and allowing stories to be heard through the case study approach. Emerging out of those stories, the Commission has ventilated questions of culture, and the Commission's Interim Report has identified culture as a key issue in a number of respects. Following on from the hearings and Interim Report to date, the sector and broader community can expect the Commission to make further strong comments and recommendations on culture in its Final Report.

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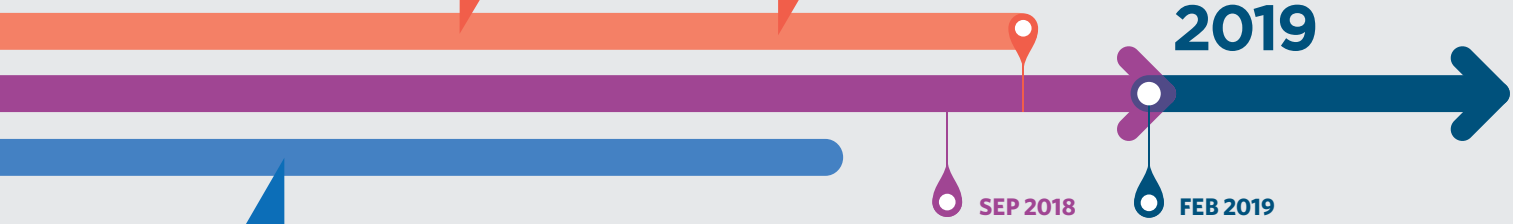
What is a Royal Commission?

In Australia, Royal Commissions are the highest form of inquiry on matters of public importance. A Royal Commission has broad and coercive powers to gather information to assist with its investigations and inquiries. These powers can compel individuals to participate in the inquiry through the summons of witnesses to give evidence and produce documents, the issuing of search warrants, and punishment for contempt. On the other hand, the Commission cannot resolve individual disputes. It cannot fix or award compensation or make orders requiring a party to a dispute to take or not take any action.

"Good culture and proper governance cannot be implemented by passing a law. Culture and governance are affected by rules, systems and practices but in the end they depend upon people applying the right standards and doing their jobs properly" (Interim report)

"Changing culture in the Australian banks may not be easy and may take time" (Interim report)



"The industry universally pays lip service to the values of being customer focused, "doing what is right" for customers and acting with integrity, the reality is that the culture of many participants in the industry has tended, at least historically, to be sales-driven and to favour their short term financial interests over the interests of customers."
ASIC Submission, 7 May 2018

Global regulatory update

Over the next few pages, we undertake a whirlwind tour to look at some of the initiatives which have been underway in key jurisdictions in 2018, and what this means for 2019. The overall picture that emerges is one of the regulators, Janus-like, having one foot in the past and one foot in the future, balancing delivery of the final stages of the post-crisis reforms with development of regulatory policy that responds to innovation like crypto-assets and crowdfunding. And while the ancient Roman god Janus was linked to auspicious beginnings, it is perhaps too early to predict whether the regulators' efforts signify a similar stage.

Delivering past promises

2018 has the significance of being the 10 year anniversary of the financial crisis. The regulatory interventions in response to the crisis at global, regional and national levels were numerous - from changes to capital requirements, through fundamental reforms to the operation of markets, to pinpointing focus on responsible individuals. Nothing quite underlines the scale of 2017-18 as the volume of regulatory change that followed in its wake. A decade later, regulators and firms are still working to deliver the reforms, but – it's fair to say – do appear to be reaching conclusion.

Today, efforts are – broadly speaking – less about implementing new regulation and more about making enhancements and calibrating. For example, in the UK, the senior managers' regime which was implemented for banks and large investment firms in 2016 is being extended to other financial services firms, bringing continuity of approach across the sector. In the US, the recently passed Economic Growth, Regulatory Relief, and Consumer Protection Act is amending the seminal Dodd-Frank Act, requiring regulators to revisit key post-crisis legislation. At a global level, the Financial Stability Board is pivoting away from designing new policy to focus on evaluating the effects of the G20 reform agenda.

In Australia where some of the reform momentum has lagged, the impetus of the Royal Commission is expected to mean that it catches up to and potentially overtakes Europe and the US in its regulatory expectations.

Looking to the future

While the financial crisis has dominated regulatory debate over the past 10 years, Fintech has blossomed. If anything demonstrates the speed of this change, it is bitcoin – from the unremarkable registration of the domain name bitcoin.org in 2008 to the frenzied media coverage of crypto-asset prices in 2017-18.

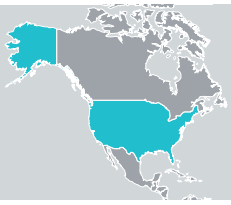
Regulators face real challenges in the FinTech space, and not least from the speed of development and adoption of innovative, digitalized products and services. FinTech confronts regulators with an unprecedented mountain range of steep learning curves – whether its crowdfunding platforms, robo-advisers, crypto-assets or any of the myriad of offerings.

Added to this is the threat posed by the flip-side of innovation – how to ensure that the financial markets are safe from digital attack or digital misuse?

"Resilience" – operational, cyber, IT – seems set to become the watchword of 2019, and perhaps the next decade. Put simply, it's the regulatory question of "how quickly can you fully recover?"

Open Banking is expected to profoundly affect the retail markets and the assessment of loan affordability and credit risk, and has the potential to improve both access to and the quality of advice. That change has begun to take effect in Europe, and, again, Australia is close behind.

Spotlight on
US



Multiple agencies in the US are taking action to encourage financial innovation

On February 3 2017, President Trump issued Executive Order 13772, which sets out the core principles for regulating the US financial system. Under the Executive Order, the Treasury Department is tasked with making a series of reports examining the US financial regulatory system and detailing executive actions and regulatory changes that can be undertaken.

Three reports were issued in 2017. In July 2018, the Treasury Department issued its fourth report under Executive Order 13772, which covers nonbank financial institutions, financial technology and financial innovation. Treasury's recommendations in this report include:

- adapting regulatory approaches to changes in the aggregation, sharing, and use of consumer financial data, and to support the development of key competitive technologies;
- aligning the regulatory framework to combat unnecessary regulatory fragmentation, and account for new business models enabled by financial technologies;
- updating activity-specific regulations across a range of products and services offered by nonbank financial institutions, many of which have become outdated in light of technological advances; and
- advocating an approach to regulation that enables responsible experimentation in the financial sector, improves regulatory agility, and advances American interests abroad.

The report recognises some regulatory changes that have already been proposed or implemented by various federal financial regulators to encourage financial innovation. Most notably, in July 2018, the Office of the Comptroller of the Currency (OCC) announced that it will begin accepting applications for the special FinTech charters initially proposed in 2016. The OCC FinTech charter would allow chartered marketplace lenders and payment companies to make loans and take deposits, yet reduce licensing and regulatory cost by consolidating supervision under one primary national regulatory structure. However, since the announcement, New York State's Department of Financial Service (NYDFS) has filed a lawsuit against the OCC over the action, claiming it can have the effect of destabilising financial markets more effectively regulated by the state.

At least one all-mobile bank, Varo Bank N.A., has received a traditional full-service national bank charter from the OCC.

The Federal Deposit Insurance Corporation (FDIC) has indicated that lending companies can apply for an Industrial Loan Company (ILC) charter to be able to offer banking-related products and services, without being subject to extensive regulations applicable to the traditional banking sector, including oversight by the Federal Reserve. Nevertheless, several FinTech companies recently withdrew their ILC charter applications. The withdrawal announcements all indicated that these companies have not precluded the possibility of refiling later, but their current dialogues with the FDIC might have hit a roadblock.

The Consumer Financial Protection Bureau (CFPB) announced the creation of the Office of Innovation in early May this year to focus on consumer-friendly innovation. The new division was created based on work previously done under Project Catalyst. It is expected that the CFPB will set up a sandbox initiative working with the Commodity Futures Trading Commission (CFTC). The new leadership at CFPB also indicated that they will be less inclined to take aggressive enforcement actions against FinTech startups, and would also reconsider the controversial payday lending rules the CFPB issued previously.

As the US has a dual-banking regulation system, the state banking regulators are also eager to share the responsibilities in regulating FinTech companies. The Conference of State Bank Supervisors (CSBS) launched Vision 2020 to modernise state regulations to FinTech companies. One important objective of Vision 2020 is to redesign the Nationwide Multistate Licensing System (NMLS) to enable regulators to transform the licensing and supervision of FinTech companies to an integrated, 50-state system. Other initiatives include forming a FinTech advisory panel and harmonising multi-state supervision.

US federal and state regulators are yet to develop a comprehensive regulatory framework for FinTech companies. However, rapid development in this new sector can greatly shape the market position of traditional banks and should be monitored closely.

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Spotlight on
UK

Extending the FCA's rulebook and powers

The Senior Managers and Certification Regime (SMCR) was put in place in March 2016 for banks, building societies and certain investment firms in order to focus accountability on a smaller number of senior individuals, encourage such individuals to take greater responsibility for their actions and to make it easier for firms and regulators to hold individuals to account.

The regime was developed after criticism of the regulatory system following the perceived failure to hold individuals to account for the issues which led to bank failures and bail outs during the financial crisis. Among other things, SMCR was designed to assist the regulator in linking control failures to specified individuals, where previously, responsibility for a particular area of the business or action was unclear, or split between several individuals.

SMCR is now being extended to insurers (from 10 December 2018) and to the remainder of FCA-regulated firms (from 9 December 2019).

By extending the regime in this way, large investment banks, insurers, retail banks, asset managers, consumer credit providers and sole traders are all subject to enhanced individual accountability. However, the extension categorises firms in three tiers: enhanced firms, core firms, and limiter scope firms based on the size and complexity of the firm.

Even with the tiering system, the changes will likely increase the costs of compliance for all firms that find themselves within the regime, requiring advice and careful consideration as to who should take on a senior manager role and how responsibilities within the firm should be mapped to particular senior managers. Additionally, firms who are brought within SMCR will have to consider how to put in place internal processes and procedures to meet SMCR obligations: from certifying that certain employees are fit and proper (a role which shifts from the regulators to the firm post-SMCR and which requires heightened consideration of staff codes of conduct and enforcement/disciplinary processes) to ensuring that responsibilities are allocated correctly and updated as required. Training for the majority of firms' staff will also have to be provided on an ongoing basis given that SMCR encompasses a number of different employees who were previously not formally covered by the pre-SMCR Approved Person's Regime.

As noted above, a key reason for introducing SMCR and extending it to all regulated firms is to assist the regulator in holding specified individuals accountable for failings within the firm.

SMCR does not give the FCA or PRA any new enforcement powers, but it does clarify which individual is responsible for the area or function in which the complained-of conduct arose. The FCA considers SMCR to be central to the promotion of a culture of accountability at firms, with a view to preventing misconduct, rather than simply enforcing against breaches of the rules after the event. This has been seen in practice with FCA Enforcement activity notably increasing following the initial implementation of SMCR, in keeping with an increase in Enforcement activity more generally. Figures this year show that 66% of the FCA's Enforcement caseload relates to actions against individuals.

In July 2018, the FCA published a discussion paper relating to the protection of consumers. In this, it mulls the introduction of a duty of care on firms when dealing with consumers. The precise scope of this duty is unclear but could range from an obligation to exercise reasonable care and skill when providing a product or service to a more formal and onerous fiduciary duty. The goal of such new duty would be to close any gap in current regulation which may lead to customers having inadequate protection from actual or potential harm.

The FCA suggests that some support the move given the "extent and longstanding nature of customer detriment" which requires cultural change within firms and the market, while others reject the idea on the basis that existing FCA rules, including the SMCR, have the effect of imposing a sufficient duty of care on firms and individuals. Responses to the paper and due later this year, with most commentators suggesting that the FCA seek to exercise its current rulebook effectively rather than granting additional powers which increase compliance burdens and Enforcement risk without substantially improving the position of the consumer.

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Spotlight on GERMANY

With Brexit becoming reality in the near future, Germany could become the location of choice for doing business in Europe. The legislative framework, and in particular its implementation, may be the 'deciding factor' or the 'deal breaker' for some banks. Most of the laws regulating the German banking sector are based on European Directives/Regulations. Thus, while the root of the laws is similar throughout the EU, the way they are carried out by key authorities may differ. The key authorities are the European Central Bank, but in particular BaFin (Bundesanstalt für Finanzdienstleistungsaufsicht), which is the financial regulatory authority in Germany.

In 2018, there have been some key regulatory developments which show that Germany is still dedicated to the global approach of strengthening international regulatory standards, mostly driven by European initiatives.

Implementation of European Directives in 2017/2018

Germany has completed the implementation of some major European Directives and transposed these into domestic laws:

- As of 3 January 2018, the Second Markets in Financial Instruments Directive (MiFID II) was transposed into the German Securities Trading Act (WpHG). Changes related to extended documentation obligations in regards to investment advice (taping), and general transparency regarding fees and necessary trainings personnel.
- As of 26 June 2017, the implementation of the 4th AML Directive was completed, inter alia, with the coming into force of the new amended AML Act (GWG) and its vastly extended catalogue of administrative sanctions.
- As of 13 January 2018, the revised Payment Supervision Act (ZAG) came into force, implementing the second payment services directive (PSD II). Payment service providers had until mid-February to provide information on their future procedures for risk and security topics.

BaFin's minimum standard for risk management and IT

An important role that BaFin has, is to specify the requirements under the statutory laws. BaFin does this through guidelines and letters made publicly available on its website. Two recent publications are important.

- In October 2017, BaFin published guidelines for banks and other obliged entities under the German Banking Act (KWG) relating to the minimum requirements risk management systems within the institution (MaRisk). Consultation of this framework had been going on since February 2016.
- BaFin's minimum requirements regarding IT in financial institutes (BAIT) were released in November 2017, and provide guidance on requirements for, inter alia, IT systems and IT-governance.

BaFin and Digitalization: The BAIT guidelines are merely one step for BaFin tackling the field of IT infrastructure and digitalisation. BaFin recently published an analysis of digitalisation and its impact on the regulatory framework. Digitalisation is one of the topics that BaFin addressed in many recent publications and developments in this area are to be expected.

BaFin and Brexit: On 8 June 2018, BaFin and the European Banking Institute hosted a conference on pressing issues relating to Brexit. BaFin stressed that it would take a 'solution-oriented' approach and that it aimed to mitigate any operational risks. The conference was also highlighted that licensing and authorisation was under pressure and BaFin noted that it would be willing to make some temporary pledges towards companies aiming to relocate to Germany.

Developments in (Collective) Consumer Protection: Collective class actions, as they exist in the USA, are generally foreign to German procedural law. Yet, with 'Dieselgate' becoming public, the German legislator has been under some pressure to provide an effective form of collective redress for consumers. The response was the implementation of the so-called 'representative declaratory action' (Musterfestellungsklage) in November 2018.

This action allows qualified associations to sue on behalf of consumers. This type of declaratory action may invite litigation against banks and facilitate mass actions in cases where a bank violates consumer protection laws. In general, consumer protection is one major goal of BaFin's supervisory conduct and further developments can be expected in this area in the future.

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Spotlight on
FRANCE

The french prudential authority's increased focus on AML compliance

The recent increase in terrorist activity in Europe, and more specifically in France, as well as major financial scandals like the 'Panama Papers', have had a direct impact on the financial industry in the country. In the past two years, the French Authorité de Controle Prudentiel et de Résolution (the 'ACPR') has placed financial institutions under heavy scrutiny as regards their compliance with Anti-Money Laundering and Counter-Terrorist Financing (AML) regulations. During this period, the ACPR carried out over 54 on-sight inspections and issued numerous follow-up letters and/or disciplinary proceedings where the ACPR identified potential breaches of the regulation.

This trend is likely to continue in the coming year, as France is preparing to be assessed by the Financial Action Task Force (FATF) in 2020 for its implementation of the FATF Recommendations and for the robustness of the country's system for preventing criminal abuse of the financial system.

The ACPR's increased focus on AML compliance has placed a significant and somewhat disproportionate burden on financial institutions. The average length of an ACPR on-sight inspection is between six months to one year, during which it expects the audited entity to provide a significant amount of information about internal AML processes, controls and training, client due diligence carried out over several years, and the various IT tools used to deal with AML compliance.

While the inspections are meant to be carried out in a spirit of collaboration, in reality the tight deadlines imposed by the ACPR for providing information forces audited entities to set up specific taskforces to deal with these regulatory requests, and to seek professional guidance from lawyers and consultants whenever a potential issue is identified. The ACPR's on-sight inspections are thus extremely time-consuming, and potentially disruptive and costly for the audited company.

Financial institutions face an additional difficulty with the ACPR's lack of practical understanding of some of the financial industries it oversees, and of how AML regulations should be applied to them. Indeed, AML regulations implemented in France and the various Guidelines issued by the ACPR over past years are mostly designed for the business carried out by banks and insurance companies, and rarely take into account the specificities of the business models of companies engaged in money transfers, payment services, and other new types of businesses in the financial sphere.

The best example of this issue concerns 'business relationship' clients, in relation to which financial institutions must engage in client due diligence under AML regulations. While it is relatively easy to concede that clients with a bank account or a life insurance contract would qualify as having a 'business relationship' with a standard retail banking institution or insurance company, the task of establishing which clients fall within this category in relation to money transfer providers is significantly more complex, considering how volatile and intermittent the clientele of these institutions re. Little guidance is provided by the ACPR as to its expectations, and yet the regulator is currently challenging many money transfer service providers on their client due diligence process.

Bearing these difficulties in mind, financial institutions should be alert to the need to explain the specificities of their business to the ACPR, and how they consider the AML regulations should be applied to them. Seeking professional legal advice to assist them in this arduous task could be game-changing, especially when dealing with new types of financial services and structures.

Whatever financial services they provide, multinational and European market players should also bear in mind that even though AML regulations applicable in France are based on EU AML Directives and on FATF Recommendations, significant local particularities were created when these were implemented into French law. The ACPR expects multi-jurisdictional financial institutions operating in France to adapt their compliance process and due diligence to the specific requirements of French law, without the option of relying on basic compliance with the principles of EU AML Directives.

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Spotlight on

United Arab Emirates

Focus on Fintech

In 2017, the Dubai Financial Services Authority (DFSA), the regulatory body which licences and supervises financial services firms in the Dubai International Financial Centre (DIFC), introduced a new category of licence, an Innovation Testing Licence (ITL). This restricted financial services licence allows qualifying firms to develop and test innovative financial technology concepts from within the DIFC, without being subject to the full regulatory requirements that normally apply to regulated firms.

Firms that have benefited from the ITL scheme include a company that is developing software for face-to-face payments via smartphones without the need for internet access and a firm that is developing the use of artificial intelligence to support portfolio management for private wealth management providers.

On 16 May 2018, the DFSA announced an expansion to the scheme in response to the level of interest from Fintech firms and will now provide greater support to applicants through the licensing process, and identify targets that will enable them to achieve a full licence in an agreed timeframe.

In September 2018, the Abu Dhabi Global Market, a financial freezone similar to the DIFC and based in the Emirate of Abu Dhabi, announced that its own financial technology hub, RegLab, would be admitting a wave of new firms to what is now the largest regional and second largest global Fintech start up centre.

UAE Online Security Register now live

The UAE Federal Law No. 20 of 2016 on Mortgaging of Moveable Assets as Security for Debts (the 'Pledge Law') came into force on 15 March 2017. The implementing regulations for the Pledge Law have been recently issued by way of Cabinet Resolution 5 of 2018 dated 1 March 2018 (the 'Implementing Regulations'). The Implementing Regulations provide guidance on the process of registering security under the Pledge Law. Emirates Development Bank has been appointed to manage and operate the online security register (the 'Online Security Register') by way of Cabinet Resolution 6 of 2018 dated 1 March 2018. The Online Security Register can be accessed through a portal on the website of the Emirates Moveable Collateral Registry Corporation.

The Pledge Law applies to pledges over tangible or intangible moveable assets that exist at present or in the future. It introduces the following key changes:

- Lenders are allowed to register their security over moveable assets by requiring the registration of mortgages over moveable assets in a publicly accessible security register;
- The Online Security Register is accessible online to the public free of cost, and allows both UAE and non-UAE entities to register their security interest;
- Future property may be secured under the Pledge Law. This development will be particularly relevant to security over bank accounts, where it was previously not possible to secure fluctuating balances;
- Transfer of possession (actual or constructive) is no longer required for a beneficiary to take a pledge over an asset; and
- The pledgee is allowed direct recourse against the pledged goods in certain limited circumstances without recourse to the courts.

This is a welcome development in the UAE as it brings in greater transparency and clarity in the market for secured lending and provides lenders with the requisite information while taking security over moveable goods in the UAE.

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Spotlight on
ASIA

Mitigating misconduct risk via senior management accountability

In recent years, key regulators around the globe have placed focus on senior management accountability, and have introduced regimes to help identify persons performing significant functions at financial institutions and to hold them accountable. This is part of a global shift towards prevention of misconduct, rather than solely relying on sanctions after the fact.

Hong Kong was the first in Asia to introduce a senior management accountability regime. The Securities and Futures Commission's (SFC) manager-in-charge (MIC) regime and the Hong Kong Monetary Authority's (HKMA) corresponding regime were fully implemented in the past year. The SFC is conducting a thematic review of licensed firms' management structure and effectiveness, including board governance and responsibilities of MICs.

In February 2018, Bank Negara Malaysia released a discussion paper on responsibility mapping targeted at banks, investment banks, Islamic banks, insurers and other institutions. It aims to introduce the regime in 2019.

The Monetary Authority of Singapore (MAS) launched a consultation on proposed Guidelines on Individual Accountability and Conduct two months later. The proposed guidelines are intended to apply to most MAS-regulated entities, including banks, insurers, financial advisers, capital markets intermediaries and infrastructures. Implementation is targeted for the final quarter of 2018.

The above regimes are framed by regulators as guidance (or clarification of existing expectations) and a way of gathering information about financial institutions' senior management, rather than new requirements. Singapore's proposed guidelines are the least prescriptive, adopting an outcomes-based approach. All three regimes require preparation of responsibility maps or management structure information.

The focus of the regimes is generally on senior managers who are responsible for key business lines and key support functions, such as risk, compliance, accounting and information technology. According to the SFC, as of 31 March 2018, close to 40% of MICs were non-licensed persons. The human resources function is included in Singapore and Malaysia's proposed regimes, and Malaysia has also proposed including the legal function. The Singapore regime covers senior managers as well as less senior employees in 'material risk functions'.

The regimes can apply to senior management based outside of the relevant jurisdiction, as a result of the global and regional nature of many senior roles within banking groups. Hence, for example, individuals in particular positions may be subject to multiple regimes. In Hong Kong, where responsibilities for a particular function or business line are shared between two individuals, both individuals will be regarded as MICs. Although this can create an added layer of complexity in terms of ensuring compliance, the regimes provide an opportunity for financial institutions to reconsider and enhance their governance structures.

> The regimes provide an opportunity for financial institutions to reconsider and enhance their governance structures.

Technology revolution shows no sign of abating

The recent rapid developments in fintech and cryptocurrencies show no sign of abating. Regulators are faced with the need to assess whether (and if so, how) existing regulatory frameworks can be applied in an increasingly digital environment, and if not, whether new regulations should be introduced. Some regulators have seen the need to issue further guidance, such as guidelines on online distribution and advisory platforms (including robo-advisers) by the SFC and the HKMA, which will come into effect during 2019.

A number of regulators in Asia, such as Hong Kong, Singapore, Malaysia and Thailand, have established sandboxes for firms to trial innovative products and have a dialogue with a dedicated team within the regulators. Recently in August 2018, a global sandbox was proposed as part of the establishment of the Global Financial Innovation Network, to provide firms with an environment in which to trial cross-border solutions. The HKMA and the MAS are members of this network.

A game changer in the innovation space is open banking, which enables bank customers to share their personal financial information with third parties to enable better comparison of financial products. It leads to increased competition and transparency, and in turn, better products. Singapore took the lead in Asia by launching an open banking 'playbook' in late 2016. The HKMA announced its open banking framework in July 2018, with a phased implementation from mid-January 2019 onwards.

Asia regulators are also embracing technology in their own supervisory and regulatory roles (suptech and regtech). For example, the SFC has indicated that it is looking at developing a common industry standard prescribing the content and format of trading-related data to be kept by firms, which can be easily uploaded to the SFC's platform for analysis. The HKMA is also conducting a deep dive study on the need for, and possibilities of, machine-readable regulations of selected regulatory requirements. Some regulators are also collaborating with the industry in new initiatives, such as the Bank of Thailand's Project Inthanon announced in August 2018, which involves developing a central bank digital currency for wholesale fund transfers.

In the past year, we witnessed an unprecedented boom in the global cryptocurrency market. A number of regulators in Asia, including those in Hong Kong, Singapore and Malaysia, took swift action and issued warnings to cryptocurrency exchanges and initial coin offering (ICO) issuers where breaches were likely to have occurred. Some regulators issued guidance to the industry and published statements to remind the public to be mindful of the risks when trading in cryptocurrencies or related products. Mainland China continues to ban ICOs and trading of cryptocurrencies and recently indicated that it would block access to offshore cryptocurrency exchanges whose websites can be accessed locally.

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Spotlight on AUSTRALIA

The regulatory landscape for Australian banks will be shaped for years to come by the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry.

Structural changes are already well underway, as banks divest most of the non-banking businesses that have supplied the overwhelming majority of the instances of misconduct examined in the Commission. Whether that results in an improvement in customer outcomes remains to be seen. While there has been much discussion of the conflicts inherent in vertical integration, it is far from clear that the misconduct in question has been a consequence of those conflicts. Largely, that misconduct appears to have been attributable, not to deficiencies of structure, but to deficiencies of culture: 'greed' as the Commissioner pithily puts it.

What then, is the prescription for addressing cultural failings? Certainly it does not appear as though substantial changes to the law will be called for. As the Commissioner has observed, the misconduct in question was already a breach of the law. Instead, the main recommendation for change has been that regulators more rigorously enforce through the Courts the laws that already exist. In the Commissioner's view, where the regulator suspects a breach of the law has occurred, that suspected breach should be prosecuted through the Courts unless there is a public interest reason not to do so. Indeed it is, according to the Commissioner, a mark of failure that the regulators do not run more losing cases.

Clearly, regulatory litigation has a role to play in protecting the interests of consumers. Where conduct is so egregious that it cannot go unpunished, for example because it involves intentional wrongdoing, or where consumers will not otherwise receive redress, the public interest is clearly served by recourse to the Courts.

However, if culture is at the heart of the problem, it is difficult to see how a blizzard of litigation is the cure.

First, changing the culture of a large organisation requires a significant investment of time and resources. A wave of regulatory litigation seems liable to divert the attention and resources of banks to defending past conduct rather than preventing future misconduct.

Secondly, litigating marginal cases is less likely to produce better consumer outcomes than regulators working co-operatively with the regulated. Regulators have been exhorting banks to adopt a less adversarial, more co-operative, approach to regulatory engagement. It would seem to be at odds with that exhortation for the regulators now to adopt a more adversarial stance with the banks.

Whatever one's view of the Commissioner's call to regulatory arms, there is little doubt that the project of cultural change is an urgent one for banks. Successful implementation of that change will not only minimise a bank's risk of future contravention and exposure to penalties, it will enable a reset of the regulatory relationship. While in the short term being open and transparent with the regulators about emerging issues runs the risk of attracting enforcement proceedings, in the longer term, it will hopefully earn a degree of latitude where issues do emerge. For a regulator to take enforcement action against a bank that has clearly made significant efforts to avoid contravention, and has been open and transparent about any shortcomings in that effort, would suggest that banks would be better served adopting a more adversarial approach. Hopefully even the Commissioner would accept that that would be contrary to the public interest.

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Whatever one's view of the Commissioner's call to regulatory arms, there is little doubt that the project of cultural change is an urgent one for banks.

The growth of securities class actions: What does this mean for investment banks?

The risk of shareholder claims against public companies, relating to flaws in disclosure, affects capital markets across the world. Securities class actions are relatively commonplace in the US and have become more prevalent in Australia and the UK in recent years. The obvious targets of this type of action are public companies issuing debt and equity securities in a prospectus, listing particulars, offering circulars or whose securities are the subject of continuous disclosure obligations. This of course includes banks, which issue debt and equity securities as part of their capital mix. What, however, are the additional risks for investment banks acting in roles assisting their issuer clients such as arranger, co-ordinator, underwriter, financial adviser and/or sponsor?

Why are securities class actions on the rise?

A number of international and domestic factors are contributing to the growth of securities class actions.

One feature, which has certainly been a trigger for claims in the UK, is the fact of large losses suffered across the globe during the financial crisis of 2008.

The fall in share prices as a result of the crisis saw groups of shareholders seeking to recover those losses, principally from issuers. Increased regulatory oversight and international investigations have also exposed regulatory failures by financial institutions and other corporate issuers, which have resulted in securities claims being actively explored.

A driver of growth outside the US has been the so-called 'Morrison effect', triggered by a decision of the US Supreme Court. This significantly restricted the extra-territorial reach of the US courts in securities litigation, forcing claimants to look to other jurisdictions to pursue claims.

Changes to the litigation landscape have also had a significant impact. Specialist claimant boutiques are pursuing potential claims aggressively, financially assisted by third party funders, who are generating relatively sizeable funds to deploy in pursuit of such claims.

There are also domestic factors. The US is usually considered to be the most active market for securities litigation, driven by issuers' strict liability for false or misleading statements or omissions in a registration statement, statutory anti-fraud provisions and an opt-out regime which provides economic incentives for claims to be brought on behalf of a class.

Costs issues are also influential; the availability of contingency fees and the absence of a 'loser pays' system provide incentives for claimants whilst the substantial cost burden of wide-ranging disclosure exercises and the risks inherent in a jury trial provide incentives for defendants to settle. In addition, US case law has provided claimants with a potential route to establishing their reliance on alleged defects by allowing the 'fraud on the market' theory to create a rebuttable presumption of reliance.

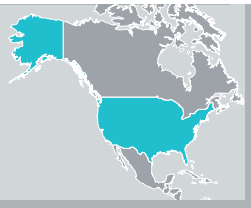
In the UK, the absence of an opt-out class action regime is a clear hurdle to securities class actions, but the fact that claims based on untrue or misleading statements or omissions in prospectuses do not expressly require reliance to be established helps to overcome this as it is easier to build a class if there is no requirement for each shareholder to prove individual reliance. Combined with a fast-developing litigation funding market and the growth in conflict-free claimant law firms, securities litigation is a growing trend notwithstanding the opt-in nature of the regime.

The level of activity in Australia is also high, driven particularly by the strict liability of issuers under the continuous disclosure regime, the opt-out nature of the regime for representative actions and a deep and active litigation funding market.

Class actions are therefore likely to remain a significant risk arising from capital markets transactions, which affects financial institutions both as issuers of debt and equity and in their performance of investment banking roles for their issuer clients. The potential exposure of investment banks in the latter roles has, to date, received less consideration. Such claims may, of course, be particularly attractive in circumstances where the issuer itself is no longer a viable source of recovery.

Class actions are therefore likely to remain a significant risk arising from capital markets transactions, which affects financial institutions both as issuers of debt and equity and in their performance of investment banking roles for their issuer clients.

Spotlight on US



- Typical securities claims in the US are made under the anti-fraud provisions of the US securities laws, including the Securities Act 1933 and the Securities Exchange Act 1934.
- There is liability under the anti-fraud provisions of the US securities laws if the offering documentation contains an untrue statement of a material fact or omits to state a material fact that is required or is necessary to make the statements not misleading.
- The issuer itself has virtually no defences available so its liability is essentially strict.
- Other potential defendants, including the underwriting banks, have a defence if they can establish reasonable grounds for believing that the misstatements in question were in fact true.
- The availability of a 'due diligence defence' or 'defence of reasonable investigation' underlies many of the due diligence procedures that investment banks apply when underwriting securities offerings in the US.
- What constitutes appropriate due diligence, or the reasonableness of the investigation, will also depend on whether statements in the registration statement or prospectus have been tested by experts.

Spotlight on UK

- Typical securities claims in the UK are brought on a statutory basis.
- Investment banks performing roles for their issuer clients (e.g. as sponsor) are protected from the risk of having to defend claims for untrue or misleading statements in, or omissions from, published information other than prospectuses because only the issuer itself can be sued (although their conduct will of course be subject to the due skill and care requirements of the applicable regulatory regime).
- The position is less clear, however, in relation to claims concerning prospectuses, where there is potential for a claim against the arranging or underwriting investment banks as 'persons responsible' for the prospectus.
- There are challenges, though, for claimants in successfully pursuing such claims against investment banks. It is, for example, the issuer and its directors who provide responsibility statements in the prospectus, and parties are expressly not liable if they merely 'provide advice' as to the content of the document in a professional capacity (which will likely cover at least some of the investment banks' roles).
- If they are responsible, the banks would have a defence where reasonable belief in the accuracy of the statement can be established.
- Investment banks could also be sued by shareholders outside the statutory regime, for example for fraud or misrepresentation, although such claims may be less amenable to class actions because of the difficulties in large groups of claimants showing that they relied on the statements in question, in the absence of any judicial support for a market-based theory of reliance.
- Claims may also be brought against investment banks based on other duties of care, for example through an assumption of responsibility to investors for the performance of one or more of its specific roles on a transaction.

Spotlight on Australia

- Typical Australian securities class actions involve claims that disclosure or non-disclosure has negatively affected the price of the company's securities, causing loss to shareholders.
- Most actions are based on an issuer's liability for contravention of continuous disclosure requirements or statutory prohibitions against conduct, in relation to financial products, that is misleading or deceptive or likely to mislead or deceive.
- Persons 'involved in' an entity's continuous disclosure contravention may also be liable, but have a defence if they took all reasonable steps to ensure compliance and believed on reasonable grounds that the entity was complying.
- The statutory prohibitions on misleading or deceptive conduct entail an objective test, focussing on whether a reasonable shareholder would be misled or deceived.
- Silence or omission can constitute misleading or deceptive conduct. Representations with respect to future matters are deemed misleading unless there are reasonable grounds for the representation when made. Whether reliance is required to establish causation remains controversial.
- A concept of 'market based causation' is asserted by claimants (alleging that "the market" relied on and was misled by the disclosure or omission), and has not yet been ruled upon by the Australian High Court.
- Securities class actions may also be based on the statutory regimes for defective disclosure in prospectuses and product disclosure statements.
- Liability under both regimes can extend beyond the offeror/issuer, to underwriters and advisers.
- The key defences to prospectus liability are due diligence and reasonable reliance (where the defendant placed reasonable reliance on information given by another person). Under the product disclosure statement regime, a defence is available to persons involved in the preparation of the product disclosure statement who took reasonable steps to ensure it would not be defective.

Market practices

Since capital markets are by their nature global, practices have developed to seek to provide processes and customary documentation to protect against the risk of material misstatements or omissions arising in the first place, given the reputational and legal issues which may arise for the investment banks involved in the transaction if they do, and to respond to investment bank internal committee requirements. Naturally, jurisdiction-specific processes are adopted to meet local requirements but many of the following elements are likely to be germane to most capital market transactions:

- Whilst investment banks are typically named in the prospectus, they do not issue responsibility statements for the content of the prospectus. Disclaimers within the document itself are also commonplace and, in private capital market transactions, so-called 'Big Boy letters' seek to prevent third parties from being named defendants, although their effectiveness will vary depending on where the claimant brings the claim.
- Representations, warranties and indemnities are given by the issuer and, in IPOs by selling shareholders, in relation to the content of the prospectus.
- Detailed and extensive due diligence is customarily performed by the investment banks (assisted by their legal advisers), including management Q&A sessions, review of documents typically contained in a data room and the drafting sessions for the prospectus, other disclosure documents and/or presentation materials.
- Verification processes may be conducted by issuers and legal counsel with a view to testing and ensuring the material accuracy and completeness of the prospectus and other presentation materials.
- So-called '10b-5 letters' from US legal advisers to both the issuer and the investment banks are typically given if the transaction involves a US element, providing a 'negative assurance' that the legal advisers in question, based on their review of certain documents and attendance at certain meetings, together with their experience in the field, are not aware of any material misstatements or omissions in the prospectus.
- Comfort packages are given by the issuer's auditors regarding financial statements and related financial and accounting data.

The various elements of a customary process described above have their origin in US execution practices for registered public offerings but, to date, their impact has remained largely untested outside the US.

Involvement of investment banks that are not defendants

It is important to recognise that, even if the investment banks are not named as defendants to a claim, they are nevertheless likely to be involved in the litigation. They will inevitably hold significant volumes of relevant documents and their employees will have pertinent (potentially critical) evidence to give in relation to the circumstances to which the claim relates. Investment banks may therefore have a key role to play in searching for and producing material for disclosure/discovery, the preparation of witness statements and then giving evidence at the trial itself. The work conducted by the investment banks and any advice provided will likely be the subject of careful analysis (and scrutiny) during any trial.

There will of course be key strategic questions in terms of the approach taken by issuers and their directors to the investment banks who assisted on any transaction which is the subject of a claim. An issuer will usually want to rely heavily on the advice it received from the investment banks, at least where the relevant liability standard is one of negligence (or higher). For example, advice about the content of, or omissions from, its disclosures or the due diligence conducted may be critical to establishing that the issuer met the prevailing standard.

An alternative course would be to accept that there were flaws in the disclosures, but that the issuer and directors should not be liable because the defects were the fault of an adviser rather than the issuer and its directors. This latter approach is likely to be a high risk strategy, and consequently much more unusual.

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Cryptocurrencies – Will AML be a showstopper?

Cryptocurrencies took the world by storm in 2017 and 2018. Regulators are facing unprecedented challenges in devising approaches to assess the systemic risks and implications of the exponential growth of cryptocurrency markets. Cryptocurrencies topped the agenda at the G20 in March 2018, and the Financial Stability Board has called for further international coordination, given the global nature of cryptocurrency markets.

While there is opportunity for cryptocurrencies to increase the operational efficiency and liquidity of alternative markets, and to provide recognition and support for new and emerging business models, there are various multi-dimensional risks introduced by cryptocurrencies.

Emergence of crypto-laundering

The original Bitcoin ethos enshrines the concept of decentralised governance, designed to bypass regulated, established systems.

As noted in a June 2014 report[1] issued by the Financial Action Task Force (FATF), convertible virtual currencies that can be exchanged for real money or other virtual currencies are potentially vulnerable to money laundering and terrorist financing (ML/TF) abuse for the following reasons:

a. they may allow greater anonymity than traditional non-cash payment methods, given that virtual currency systems are usually characterised by non-face-to-face customer relationships which may permit anonymous funding and transfers;

b. the global reach of virtual currency means that virtual currency systems can be accessed via the Internet and can be used to make cross-border payments and funds transfers or execute payments. This segmentation of services means that responsibility for anti-money laundering /countering the financing of terrorism (AML/CFT) compliance and supervision /enforcement may be unclear; and

c. components of a virtual currency system may also be located in jurisdictions that do not have adequate AML/CFT controls.

Rising to the KYC Challenge

It is no surprise that cryptocurrencies and traditional banking institutions make strange bedfellows, given that Bitcoin's blockchain was originally meant to supplant the banks. A tricky question naturally arises - how then should traditional banking institutions tackle ML/TF risks associated with their crypto clients?

Some regulators have introduced guidelines modelled after existing AML/CFT frameworks to cryptocurrencies.

However, in response to the higher regulatory expectations, there are reports that a large number of banks have closed down the existing bank accounts of cryptocurrency exchanges and crypto-related businesses, driving these businesses to seek banking solutions in less regulated jurisdictions.

This leaves crypto-related businesses outside the effective control and oversight of regulators in the major jurisdictions in which they operate.

The adoption of blockchain technology and digital assets are gearing towards dramatically changing how we transact in day to day life, and disrupting the financial industry. However, the role of cryptocurrencies in undermining anti-money laundering compliance and enforcement capabilities is often overlooked.

1. FATF Report, 'Virtual Currencies – Key Definitions and Potential AML/CFT Risks' (June 2014).

What is a cryptocurrency?

A cryptocurrency is a digital asset designed to work as a medium of exchange that uses strong cryptography to secure financial transactions, control the creation of additional units, and verify the transfer of assets.

Cryptocurrency statistics:

1910
Cryptocurrencies[2]

200
Cryptocurrency exchanges[3]

US$3.8 billion
Daily volume

Spotlight on
UK

In June 2018, the UK financial services regulators wrote to bank CEOs setting out expectations of firms' approaches to managing the risks presented by crypto-assets.[4] The UK Financial Conduct Authority provided guidance that firms offering banking services to crypto-related clients should follow a risk-based approach and exercise greater scrutiny over the activities of these clients. Suggested steps to consider include engaging with clients to understand the nature of their businesses, assessing the adequacy of the clients' own due diligence arrangements, and updating existing financial crime frameworks.

Spotlight on
South Korea

In South Korea, a country which has been a hotbed of cryptocurrency activity, the regulators introduced the Virtual Currency Anti-Money Laundering Guidelines on 30 January 2018 which required banks to conduct enhanced due diligence in their transactions with cryptocurrency exchanges, including ensuring the verification of users. Further revisions included in April 2018 mandates banks to share, both within its internal departments and with other banks, the list of overseas exchanges that it transacts with, and to make relevant suspicious transaction reports.

Spotlight on
Taiwan

The Taiwan Financial Services Coalition has asked banks to list cryptocurrency exchange accounts as 'high risk'. This means that such accounts must be observed closely, and in the event of certain volume thresholds being reached, the banks will be required to alert the regulator to check for any potential money laundering activity.

2. According to Coinmarketcap, as accessed on 3 September 2018.
3. According to Cryptocoincharts, as accessed on 3 September 2018.
4. https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/letter/2018/existing-or-planned-exposure-to-crypto-assets.pdf

Opaque

At one end of the spectrum, there are 'anonymous bitcoin exchanges', whereby users are permitted to use the services of the exchange without identity verification. This means that in most cases, only an email and a password need to be provided before users undertake trading in the exchange. In the case of decentralised cryptocurrency exchanges, as noted by FATF in a 2015 report[5], the anonymity of these exchanges and the challenges to conduct a proper identification of the participant mean that such exchanges have higher ML/TF risk.

Transparent

On the other end of the spectrum, there are cryptocurrency exchanges which carry out full KYC due diligence processes before carrying out users for services, and verify the identity of users and beneficial owners. These exchanges also distinguish between individuals and institutional clients, and carry out detailed sanctions screening and other verification checks, while relying on third-party regtech providers to offer a customer-friendly experience for users.

"Cryptocurrencies are ... more of an index of money laundering. It's going to transform how we do our business ... We should not turn our backs to it; we should embrace it and work toward a global solution because if we don't work toward a global solution it will create systemic risk."[7]

BLACKROCK CHAIRMAN AND CEO LARRY FINK, IN ADDRESSING THE INSTITUTE OF INTERNATIONAL FINANCE

Current state of play

Based on our review of cryptocurrency exchange practices, there are significant variations in how know-your-client due diligence is carried out by these exchanges.

In an effort to address money laundering risks, the Australian Federal Government has introduced new laws to cover digital currency exchanges, which include registration requirements, and various obligations such as the need to register with the Australian Transaction Reports and Analysis Centre (AUSTRAC), maintain an AML program to mitigate risk, and make suspicious matter reports.

'AML Compliant' – A pipe dream?

Some firms are looking to create what they term 'AML-compliant ICOs', whereby participants to an initial coin offering (ICO) are screened and their identities verified before they are accepted. This is done for AML reasons and also to screen out fraudulent buyers, and some have also opted to implement this only for purchases over certain thresholds.

An example is Jumio's advanced identity verification solution, Netverify, which allows ICO platforms and ICO issuers to screen users via identity verification and biometric identity verification before permitting them to participate in the ICO.

Some cryptocurrencies have developed in a bid to include inbuilt identification elements to reduce ML/TF risks. One such cryptocurrency is 'AML Bitcoin', which claims to be a similar digital currency to Bitcoin, but with compulsory multi-factor authentication, with sanctions screening.

On the reverse side of the coin, there are some privacy coins like Monero and Zcash which offer anonymity to end users. Robert Novy of the US Secret Service Office of Investigations is also one of the proponents who has called for additional legislative or regulatory actions to address potential challenges related to privacy coins.

New companies have also emerged to improve the airdrop verification process to include AML verification and screening. Crypto token management company TRM Labs, for example, recently launched a platform called SmartDrops, which allows projects to distribute tokens to select users and offers issuers analytics.

In June 2018, the Japanese Financial Security Agency announced that there will be an outright ban on all cryptocurrencies that provide a sufficient degree of anonymity to its end users. According to a news report from NHK[6], Japan's National Police Agency (NPA) has budgeted ¥35 million (US$315,000) for 2019 to fund the development of new software to help track individuals behind illicit crypto transactions.

5. FATF report dated June 2015, 'Guidance for a Risk-based Approach: Virtual Currencies'.
6. https://www3.nhk.or.jp/news/html/20180830/k10011600151000.html
7. https://www.cnbc.com/video/2017/10/13/blackrock-ceo-larry-fink-bitcoin-an-index-for-money-laundering.html

The NPA has said that the software will track suspicious blockchain transactions, and comes in response to the increasing number of suspected criminal cases in Japan that involve cryptocurrency. Early this year, the NPA disclosed it had received 669 reports of suspected money laundering from Japanese crypto exchanges in just eight months of 2017, as reported by Coindesk. Further, according to an annual report revealed by the agency in March, hackers stole at least US$6.2 million-worth of cryptocurrencies from Japanese users' exchange and wallet accounts in 2017.[8]

However, it remains to be seen whether any identification mechanisms or restrictions introduced will effectively deal with ML/TF risks. As John Kenneth Galbraith put it, "a constant in the history of money is that every remedy is reliably a new source of abuse."

Financial inclusion

The imposition of strict guidelines for crypto-related businesses in countries where AML/CTF laws and practices are more well-established also runs the risk that these are seen as barriers to entry, and pushing these players further underground or to offshore countries to seek banking solutions.

In this regard, there are more players emerging to provide new models to improve the handling of KYC/AML processes from the privacy and security perspective, all while reducing the costs of verification and working towards greater adoption of cryptocurrencies. Some jurisdictions such as Bermuda, Mauritius and Australia are also working towards greater collaboration in the blockchain and crypto space.

What is clear is that a balance needs to be struck between ensuring that ML/TF risks are identified and mitigated, and ensuring that participants in the ecosystem are not overly encumbered by the verification requirements, to avoid the scenario of a 'race to the bottom' in terms of KYC standards.

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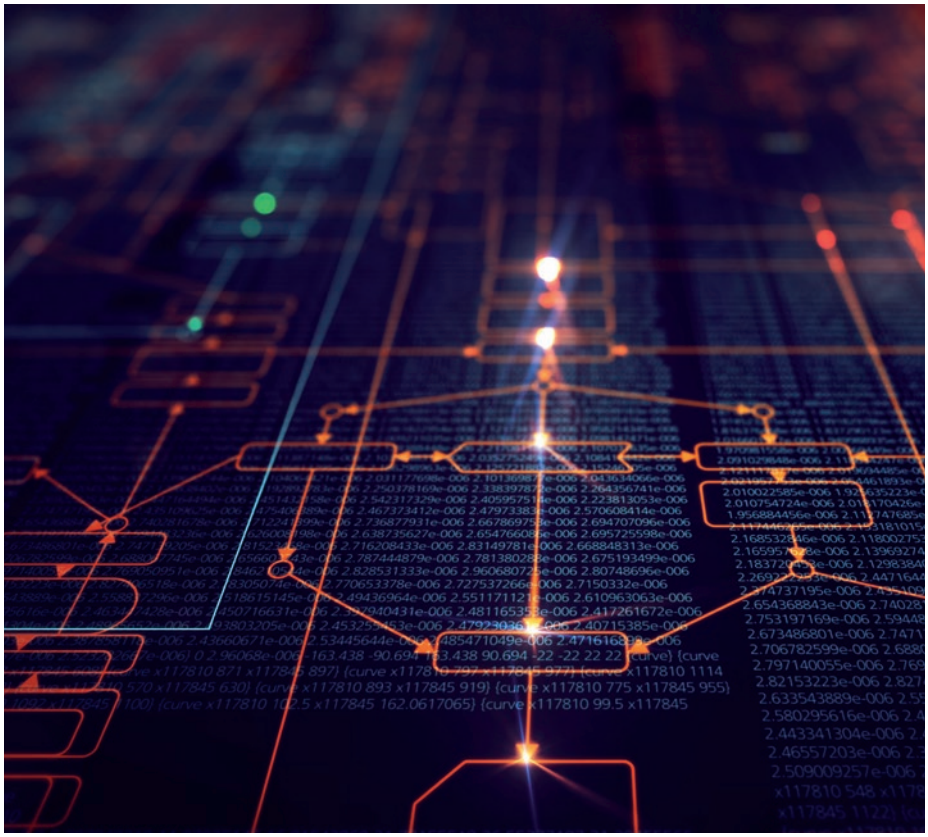
"Rob Wainwright, head of Europol, Europe's police agency, has estimated that 3-4% of the continent's annual criminal takings, or £3-4 billion, are crypto-laundered."[9]



8. https://www.coindesk.com/japans-exchanges-report-669-cases-of-suspected-crypto-money-laundering/
9. https://www.bbc.co.uk/news/technology-43025787

Being a GC in the culture age

The General Counsel in any bank will be at the heart of the discussion on culture. The crossroads of culture, behaviour and consequence present unique challenges and opportunities for legal departments.

In this article, Brett Graham, General Counsel Asia-Pacific, Morgan Stanley, and Sarah Linstead, General Counsel London, Société Générale, explore the issues surrounding the regulatory focus on culture, and what it has meant for their banks and their teams.

How important is culture within your organisation?

Sarah Linstead (SL): We have had an embracing approach to culture and conduct since the FCA announced their focus on this at the beginning of 2015. This has translated into the appointment of heads of culture and conduct at the levels of Group, Wholesale Banking, Retail Banking, UK, Americas and Asia.

We have implemented a programme to embed awareness of, and responsibility for, our behaviours and their impact on how we do business. Our Group Leadership Model details the cultural values (clients, commitment, responsibility, innovation, team spirit) that define our expectations of staff behaviour.

In the UK, there are various initiatives including culture and conduct agendas, identification of top 5 conduct risks by department, committees to review (and where necessary remediate) their conduct risk performance indicators, assessing culture and behaviours when hiring new staff, inclusion of behavioural objectives in all employees' personal development plans, the articulation of a Life@Work Framework, promoting an holistic approach to our work including our approach to training our managers and succession planning, work-life balance and well-being benefits, and a broader gender balance across our people processes and practices.

Brett Graham (BG): Culture is key. Most, if not all, people in the firm can easily name our four core values - lead with exceptional ideas, put clients first, do the right thing, and give back. These values are very important, are always top of mind and can be used to direct us in everything we do.

Do you feel that it is embedded throughout, and is it endorsed from the top down?

SL: Yes, the publication of our Group Code of Conduct and central leadership model, support from senior managers, senior appointments in our heads of culture and conduct, as well as initiatives like those above aim to bring it to life. In particular, the creation of a network of culture and conduct partners in every department, both business units and support units - is accelerating the embedding of a robust culture across the whole firm.

> "The creation of a network of culture and conduct partners in every department, is accelerating the embedding of a robust culture across the whole firm."
>
> **SARAH LINSTEAD**

BG: Our values are embedded right across the firm, and endorsed from the top. Our internal Conduct Risk Management Policy has recently been rolled out across the firm and there is now an even greater emphasis on creating the right outcomes for our people.

People of different levels were involved in developing and influencing the new policy. The Head of Compliance and I co-head the Risk Management Committee, we also have a number of people actively involved

Interviewees, from top:

Brett Graham, General Counsel Asia-Pacific, Morgan Stanley

Sarah Linstead, General Counsel, London and Head of Corporate Finance, Legal Department, Société Générale

in managing the policy, including a Conduct Risk Officer in each business unit.

For the past four years, we have held annual culture sessions. These sessions are led by a Managing Director and people from across the firm come together to explore a number of hypothetical scenarios, discuss and debate the best approach to addressing these issues. This has proven to be very effective in encouraging engagement in key issues in the firm.

In terms of giving back, each year we run a global volunteer month, which people are strongly encouraged to participate in. This initiative has been running for four or five years now and has grown significantly every year. The initiative is supported by the CEO and with the stats provided at the end of the initiative it's quite visible what activities people have undertaken. In my department I am proud to say this year we have had 100% participation rate.

How have you and your legal team been impacted by the recent focus on culture within banks?

SL: We've been treated the same as all of the business lines. Each business unit and support unit had to come up with a roadmap of how culture and conduct is managed in their department. We take a two pronged approach in Legal, looking at our own conduct and roles as well as good (and bad) conduct we see in the businesses we support.

BG: Our Asia Pacific Conduct Risk Management Committee tracks incidents which have been escalated to the Legal and Compliance Department. We have always followed this process, however, now it has become much more formalised. One significant impact is the new hires we have made globally to help us both implement and execute the process.

We have educated the business units and infrastructure groups at the firm on our Conduct Risk Management Policy and have worked hand-in-hand with the teams to ensure compliance.

When an issue gets escalated we undertake a comprehensive fact gathering exercise, which involves interviewing people. This is undertaken in a very careful manner, and where relevant, a whistle-blower protection framework is followed.

If it's a conduct risk incident then the question is: is it material? If we discern that it is material then we will determine what the right level of discipline should be.

Formalising this process has been extremely positive for the firm. The process was something that we were already doing, and it now means we are able to track issues that are occurring, and statistics which will ultimately help us to better manage and ultimately prevent future incidents.

In your view, do you think culture can be regulated?

SL: Culture per se is very difficult to regulate - despite all these initiatives the next (harder) step is making it real - what we have looked at is schemes for rewarding good conduct and punishing repeated bad conduct with financial sanctions - but these are hard to launch. There are identifiers of good culture which can help guide organisations to improve theirs, and provide regulators and auditors reference points to monitor progress. For example, describing a set of values the organisation espouses, and evaluating any evidence of adherence to those values improves behaviours and this in turn drives, and promotes insight into culture.

> "I don't think you can regulate culture but you can regulate behaviour or conduct, which can influence culture."
>
> **BRETT GRAHAM**

BG: I don't think you can regulate culture but you can regulate behaviour or conduct, which can influence culture. If you have good culture, it can encourage good behaviour. If you've got good behaviour, it will influence good culture.

Positive outcomes can be derived from regulating behaviour, which is obviously what the regulators are keen to do as seen in the FSB toolkit which identifies 19 tools that firms and supervisers can use to reduce misconduct risk. However, this will take some time, as people are still rolling out a number of different regimes.

What are the biggest challenges for you in relation to regulating culture?

SL: Drawing definite lines in grey areas - if you are going to penalise bad behaviour and set boundaries, they need to be clear, and you need to be careful not to over formalise this. Good culture is better coming from solid core values.

BG: Does more or better governance equal better conduct, or equal better culture? It depends how you define governance but I do think you need to be cautious in assuming that more governance will equate to a positive culture. I believe that it is possible to kill innovation with too much governance. Overly bureaucratic systems make it harder for us to attract smart, innovative, driven and capable people who can add value to our business and deliver for clients.

How do you think the regulation of culture will impact you as a GC and the way your legal team operates?

SL: It will be less impactful for us possibly, than other departments, as it is in our DNA as the legal department to 'do the right thing' so arguably, we are already doing it both for ourselves and vis-à-vis the businesses we support. The regulation of culture will give us more support (if we needed it) to be a stronger second line of defence.

BG: The biggest impact will be the amount of time spent on monitoring behaviour. On the positive side it's another way in which my team and I will get to interact and engage with other parts of the firm.

In terms of our newly implemented internal Conduct Risk Policy I'm fortunate that we've built a good team and the process is robust. The team is now able to come to me and say "here are the facts, here's our recommendation, and what do you think?"

The formalised process-driven policy frees me up to focus on conduct or reputational risk.

Have you done a review of your culture in the last 12 months?

SL: Yes, we have an annual conduct meeting with the FCA. In addition, aspects of our culture and conduct risk are assessed annually by our internal audit department.

BG: Yes, we conduct an annual survey and results are collated both regionally and globally. We have recently appointed a senior conduct manager who will assist in bringing this review together.

Who within the bank is in charge of addressing culture and conduct?

SL: The UK Head of Culture and Conduct who reports directly to the UK Chief Country Officer and to the Group Head of Culture and Conduct.

BG: We now have a dedicated person running conduct at a senior level.

Moving employee mental health to the board agenda

As global regulators focus on culture as a critical risk indicator, employee wellbeing and mental health is beginning to appear on bank board agendas worldwide.

According to Antonio Osorio Horta, CEO of Lloyds Banking Group, "taking action is not a nice to do; it is a business imperative for all of us".

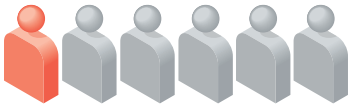
Why mental health matters?

The impact of employee mental health on society and business is well established. In the UK, an estimated 70 million work days are lost each year due to mental illness. The US will spend US$213 billion on mental health conditions in 2018, double its expenditure in 2004.

Governments have already recognised the need to address these issues. In 2017, laws came into force giving French workers the 'right to disconnect'. This ban on out of hours emails was, in part, an effort to prevent employee burn-out by protecting their private time. In Japan, where 'Karoshi', or death by overwork, and other workplace issues such as bullying have received wide media attention, employers with more than 50 employees have been required since 2016 to conduct annual mandatory stress checks of employees.

In the UK, Thriving at Work, an independent review of mental health and employers commissioned by the Prime Minister in 2017, included a recommendation that the Government consider amending the Companies Act to encourage employers to report on workplace mental health through the publication of data around sickness absence, staff survey results and take-up of Employee Assistance Programmes or Occupational Health Services.

IMPACT ON UK EMPLOYEES



1 in 6 employees currently experience mental health problems

70 million work days are lost each year due to mental illness

"Nowadays there is a huge amount of discussion at board level with many CEOs, Chairmen, and boards, who are really spending a lot of time to thinking about the issue of mental health and raising awareness on the subject."

BRIAN HEYWORTH, GLOBAL HEAD OF CLIENT STRATEGY FOR HSBC ASSET MANAGEMENT AND VICE CHAIR OF THE CITY MENTAL HEALTH ALLIANCE (CHMA)

"There's been really good progress over the past few years, but that's from a pretty low base," said Brian Heyworth, Global Head of Client Strategy for HSBC Asset Management and Vice Chair of the City Mental Health Alliance (CHMA) in London. "I think it mirrors society. Five or ten years ago there were only a few brave people who would speak about it. You had Ruby Wax, Stephen Fry, Alistair Campbell ... but nobody in business, nobody in government and nobody in sport who would discuss it. The shift within the business world began with a few brave people speaking out about mental health. Then others began to feel more comfortable talking about their own experiences. There has also been a lot more in the way of scientific studies and data gathered around mental health, which gives business leaders some data-driven evidence for them to base recommendations upon."

The top cited factors causing mental stress are work pressure and work-related harassment and bullying.

In 2017, Deloitte found that UK workplace interventions returned between £1.50 and £9 to the business for every £1 invested. A similar 2014 report in Australia found that every A$1 invested generated around A$2.30 in benefits to the organisation. Businesses have invested in employee wellbeing and mental health awareness and support. Education and training programmes on the prevalence of mental health issues and how to support colleagues suffering from mental health issues are widespread as are employer funded access to GPs, psychologists, mindfulness programmes, gym memberships and yoga classes.

Prevention as a focus

Lately however, the focus has expanded from treatment to prevention, with a particularly hard look being taken at the impact of the workplace itself on mental health issues.

"Nowadays there is a huge amount of discussion at board level with many CEOs, Chairmen, and boards, who are really spending a lot of time to thinking about the issue of mental health and raising awareness on the subject," said Mr Heyworth. "There's still a huge amount to do, but companies are now starting to focus on the specifics and those specifics include mental health first aid, training for management teams, embedding mental health into objectives, a lot more focus on prevention as well as all the more traditional things like helplines and nurses and doctors on call. So it has moved to a more cultural and behavioural focus".

Adam Spreadbury, Co-Founder of the Bank of England's Mental Health Network, reinforced the importance of not trying to address a complex issue with a simple solution. "As part of the Bank of England's commitment to building an inclusive workplace, we want all our colleagues to bring their whole selves to work. We recognise that given almost one in three people will have mental health issues at some point in their lives, it is important to provide wide-ranging and consistent support." Mr Spreadbury gave examples of initiatives in place at the Bank of England including offering managers mental health and wellbeing training and having in-house counsellors, offering courses to all staff in managing emotional wellbeing and recognising if, and when, colleagues may need help.

What does this mean for Banks?

The pressure on employees in banking and financial services is particularly acute. Longer hours, leaner teams with heavier workloads, and rapid regulatory and technological change, have all been blamed for increasing pressure on employees. In Australia, the overall prevalence of mental health conditions is highest in the financial and insurance sectors. A 2014 PWC report indicated that 33% of individuals working in the sector were experiencing a mental health condition, the most common being anxiety (reported by an estimated 30% of employees).

The findings of the UK Banking Standards Board (BSB) have highlighted particular concerns about resilience and wellbeing of employees in the banking sector. In the BSB's 2017/18 annual review, which surveyed 36,000 people from 25 banks and building societies in the UK, over 44% of respondents indicated that they often felt under excessive pressure to perform and over 25% of respondents said that work had a negative impact on their health and wellbeing.

So far, however, most industry actions have understandably treated the symptoms of

mental illness rather than address potential causes. This is likely to change as a sharper regulatory focus falls on the various factors that feed into workplace culture and drive conduct risk.

The premise that a culture which promotes accountability, responsibility and employee psychological safety is essential to reducing misconduct risk underpins much of the recommendations in the toolkit released earlier this year by the International Financial Stability Board. The Strengthening Governance Frameworks to Mitigate Misconduct Risk toolkit recommends practices which reach deep into the core business and the functions that support it, such as human resources, communications, strategy, and compensation. The toolkit suggests data points to draw upon to identify cultural drivers of misconduct including engagement surveys, exit interviews and root cause analysis of trends on staff engagement, turnover, employee relations incidents, and diversity and inclusion.

"FSB recommendations tend to become regulatory practice quite quickly," said Will Hallatt, Head of Financial Services Regulatory, Asia at Herbert Smith Freehills in Hong Kong. "Banks need to consider their organisational approach to culture, and the role employee wellbeing and mental health have within this, sooner rather than later."

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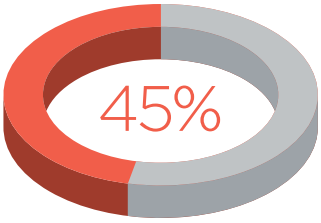
Addressing mental health is not straightforward. This is particularly so in the banking and financial services sector. Instances where employees have raised a depressive illness or anxiety condition as a contributory factor in their misconduct have highlighted the complexity that organisations face when approaching mental health issues. How can organisations assess whether a mental illness or condition, if not well managed, will affect whether a regulated individual is 'fit and proper' while also ensuring not to discriminate or unfairly stigmatise employees with mental illness?

Employee claims may lead courts, regulators and tribunals to scrutinise the support provided to employees to avoid burn-out or other negative impacts on mental health caused by the workplace. As well as the potential legal exposure, any findings critical of those support mechanisms will negatively impact an organisation's reputation.

THE COST OF MENTAL HEALTH IN AUSTRALIA

Approx. $543 million is paid each year in workers' compensation for work-related mental health conditions



It is estimated that around 45% of Australians between the ages of 16 and 85 will experience a mental illness

"Bank boards and executives will need to find a fair way to balance employee wellbeing goals and programmes with local employment and discrimination laws as well as the many regulatory requirements," said Sydney employment partner Drew Pearson. "It adds another layer of complexity to the regulatory burden on banks and financial institutions."

This burden is more pronounced for those institutions operating across borders. For example, banks operating across Asia Pacific may be dealing with a patchwork of employment laws in 12 or more jurisdictions. Meeting regulatory requirements and supporting employee mental health while also navigating resourcing demands and diverse cultural and social attitudes to mental health is a vast challenge.

Shifting culture to address risk

Australian regulators have already called out shortcomings in governance, culture and accountability frameworks as key concerns. The role of directors in setting and maintaining culture will continue to be in focus. In the same way that Australian workplace health and safety reform in 2012 focused on managing safety risk through creating a 'safety culture', we expect to see similar moves to address a 'risk culture' in banking and financial services organisations. In the safety context, this shift was largely driven through increased personal liability of directors, for example, where organisations were found to have insufficient resourcing or inadequate processes and controls in place to mitigate safety risks.

Some inside the industry believe the shift is already underway. "The industry has changed and really forced people to think about mental health in a way that maybe they hadn't previously," said Mr Heyworth.

Whatever the challenges ahead, the industry remains committed to supporting employee mental health, regardless of regulatory requirements. "Looking after employees' mental health is part and parcel of how you run a company the right way. I think the real leaders realise that the healthier and happier your workforce is – there is a direct correlation to the bottom line. So it is not some sort of hold hands Kumbaya exercise, it is a pragmatic way of modern leadership."

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