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Article

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Greed, recklessness and/or dishonesty? An investigation into the culture of five UK banks between 2004-2009

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Abstract: The author uses a multiple case study approach to examine five UK banks in her paper. The banks are Northern Rock, the Royal Bank of Scotland, Barclays, Lloyds Banking Group and HSBC. The author feels that it is appropriate to use a multiple case study here because it will be interesting to study the micro aspects of regulation and corporate governance of five UK banks. The banks have to comply with the same regulations and laws on a macro level, so it is essential to examine the differences between these banks on a micro level through reviewing annual reports and financial ratios. The case study is longitudinal, spanning across 2004-2009. In accordance to the aims of a case study, the author will describe, understand and explain the effects of the financial crisis 2007 on five UK banks. This case study provides an opportunity to examine the weaknesses and failures of corporate governance of five UK banks at a micro level. The author has two hypotheses at the beginning of the study. First, banks moved from a customer driven culture to sales driven one. Secondly, the banking culture during between 2004-2009 is one of greed, recklessness and dishonesty. With the caveat that one should not make generalisations, there is evidence from the case study that both hypotheses are correct to a certain extent.

Keywords: Banks, corporate governance, culture, micro-regulation, recklessness, greed

Introduction

The author uses a multiple case study approach to examine five UK banks in her paper. The banks are Northern Rock, the Royal Bank of Scotland, Barclays, Lloyds Banking Group and HSBC. Multiple case studies allow cross-case analysis and comparison, as well as the investigation of a particular phenomenon in diverse settings(1). Multiple cases can be used to predict similar results (literal replication) or to produce contrasting results for predictable reasons (theoretical replication)(2). The author feels that it is appropriate to use a multiple case study here because it will be interesting to study the micro aspects of regulation and corporate governance of five UK banks. The banks have to comply with the same regulations and laws on a macro level, so it is essential to examine the differences between these banks on a micro level through reviewing annual reports and financial ratios. The case study is longitudinal, spanning across 2004-2009. In accordance to the aims of a case study, the author will describe, understand and explain the effects of the financial crisis 2007 on five UK banks(2). Northern Rock was chosen as it was the first demutualised building society which was nationalised. The 'run' on Northern Rock was a particularly vivid event since it was only then that the reality of the global financial crisis was felt in the UK. It was the prelude to the second worst recession since the Great Depression.

Corporate governance of *modern* banks is an important topic. It is also a relatively new topic when the banking model changed in the late 1980s. Mulbert submits that it is during the Asian financial crisis that interest in this area emerged(3). The Basle Committee first published its guidelines on 'Enhancing corporate governance for banking organisations' in 1999. The Organisation for Economic Co-operation and Development then published its Principles of Corporate Governance in 2004(3). Academics have conducted both empirical and theoretical works on corporate governance of banks since the Asian Financial Crisis(4-6). A search on the electronic database for PhD theses of the British Library revealed 17 results for 'corporate governance of banks', none of which relates to the UK. Banks have traditionally been regarded as merely corporations. Therefore, the literature review has not truly distinguished corporate governance of banks from other companies. It is only around the late 1980s when banks started to change their business model. Up till then, banks utilised an 'originate-to-hold' model where they held onto a loan until it matures. Low interest rates at the beginning of 2000 and a search for greater profits led banks to adopt an 'originate-to-distribute' model. This model allows banks to sell loans (including corporate loans) in the secondary loan market. The 'originate-to-distribute' model gives greater liquidity; more borrowing capacity and ability to transfer risks to ultimate investors. It also allowed banks to circumvent banking regulations such as Basel II Accord on capital requirements(7). Derivatives became popular and investment banking became highly desirable and profitable. Safe banking was no longer attractive. Banking became complicated, with loans being passed down the chain in return of securitised products. Not many bankers fully analysed the risks or realised that risks were not actually passed to the ultimate investors. With profit being the ultimate goal, the business models of Northern Rock and the Royal Bank of Scotland were risky and aggressive(8, 9). The Royal Bank of Scotland acquired ABN Amro. Short-term targets combined with enormous salaries and bonuses kept the bankers taking uncalculated risks. The entire banking model has evolved from ‘relationship banking’ to ‘sales banking’. Banking was no longer seen as a personal service. Rather, it is about selling as many financial products as possible.

It is against this backdrop that the author wishes to study the culture of the five UK banks. Clearly, evidence obtained through working at a bank or interviewing bank employees would be desirable but access to banks is very difficult to obtain. Instead, this study reviewed relevant publications and annual reports of the five banks from 2004-2009 for their mission statements and corporate governance systems. The author obtained valuable insight into the culture of Halifax Bank of Scotland (HBOS) through an interview with Paul Moore, the ex-Head of Regulatory Risk at the bank. Arguably, HSBC weathered the financial crisis better than most banks since they did not require governmental assistance. Therefore, the literature on HSBC is not as extensive as the other four banks. Nonetheless, the author will conduct as much research into HSBC as possible to discover their culture. If we want to change the culture of an organisation, one must examine the values of the bank and behaviours of its employees. It will be seen that greed is the primary factor which led to the financial crisis. Other factors such as the low interest rates, deregulation, and oversight of regulators also played a part. However, as the Parliamentary Commission on Banking Standards Report 2013 states, even if the regulator was at fault, ultimate responsibility of a bank’s failure lies with the board(10). The banking scandals revealed in 2012 (fixing the LIBOR rate and allegations of money laundering) proved that banks such as RBS, Barclays, HSBC and Standard Chartered combined greed and dishonesty to sustain their business goal of profits to the detriment of many. The author submits that both corporate governance and regulatory reasons contributed to the financial crisis of 2007-2009. This case study is a study into the corporate governance aspects of the five banks. The author has two hypotheses: first, the culture in the five banks examined in this case study has shifted from customer driven to sales driven. Secondly, greed, recklessness and dishonesty formed part of the banking culture at these banks. Naturally, one should not generalise banks as a group but there is evidence that there are problems with the banking culture at the five banks. In December 2012, when Andrew Tyrie, Chairman of House of Commons Banking Standards Commission questioned Lord Stevenson, former non-executive chairman of HBOS, he said that: '*The corporate governance of this bank [HBOS] wasn't fit for purpose and the ex-chairman still appears to be in denial about it. The industry has got to get to a better place'*(11).

Northern Rock

Northern Rock was the first casualty of the financial crisis. Northern Rock's bank run on 14th September 2007 created fear and anxiety amongst the general public. Northern Rock's chief executive Adam Applegarth tried to stave off a panic rush to withdraw funds. He said: *'If I was a depositor, and I am - my funds are with Northern Rock - and given the fact that it is backed by the Bank of England, it is probably one of the safest places to be'*(12). Yet, a government blanket guarantee covering only Northern Rock was issued only three days later. Two measures of containment were implemented to stabilise the economy. First, Northern Rock was nationalised on 22nd February 2008. This was followed by the Bank of England's Special Liquidity Scheme of £50 billion aimed at providing credit to banks. This allowed banks to exchange potentially risky mortgage debts for safe government bonds. The Financial Services Authority (FSA) also tried to contain the panic. The FSA admitted failures in their supervision of Northern Rock but said they would continue to have responsibility for regulating the banking system(13). Since April 2012, the FSA has been replaced by the Prudential Regulation Authority and the Financial Conduct Authority. Alexander(14) argues that the regulator should play an active role with bank management in designing internal control systems and risk management practices. Together, they should try to achieve an optimal level of protection for stakeholders and shareholders. The traditional principal/agent model fails to take account of the important role that financial regulation can play in representing stakeholder interests in the economy. Financial regulation is necessary because of the multiplier effect that banking activities have on the rest of the economy. Supervisors and regulators are agents on behalf of broader stakeholder interests in the economy at large. It is therefore imperative that financial regulators ensure that banking and other financial institutions have strong governance structures. The FSA said that they would overhaul their procedures as a result of the weaknesses identified.

Bruni and Llewellyn have written a comprehensive case study on Northern Rock's demise. They highlighted that the demise was due to a combination of factors such as the bank's reliance on securitisation and management of low-probability high-impact risks; the supervisory and regulatory regimes and insolvency resolution procedure(15). They mentioned briefly that there were corporate governance failures at Northern Rock but did not expand on this issue. The study focuses on Northern Rock's failures in corporate governance and fills in gap in knowledge on this topic. The FSA's internal report concluded that ultimately the blame for the collapse of Northern Rock should rest with the bank's senior management: *"The boards and managements of regulated firms carry the primary responsibility for ensuring their institutions' financial soundness"*(13). Management's failure to curb excessive greed and recklessness led to moral hazard. Bank managers took too many risks and failed to monitor other players in the securitisation process such as the Special Purpose Vehicles (borrowers). Bank managers also took actions that were not in the interests of the investors, ultimate holders of the loan.

This study reviewed Northern Rock's annual reports between 2004-2009. In particular, this study reviewed the mission statement, annual reports and corporate governance literature of Northern Rock. The period of 2004-2008 should reveal the culture prior to the financial crisis. Northern Rock was nationalised in 2008 so the annual report of 2009 should reveal a different governance culture. The mission statement in the 2004 annual report states that *'Northern Rock is a specialised lending and savings bank which aims to deliver superior value to customers and shareholders through excellent products, efficiency and growth'*(16). Efficiency is clearly an important concept as it is repeated 12 times throughout the annual report. The following statement on page 7 of the Annual Report sums up the business model of Northern Rock: *'Our business model remains robust: we keep costs low, invest in product and process innovation, give our customers transparency and so add low-risk assets to our balance sheet to provide attractive returns to our shareholders. We fund this growth through retail, wholesale and securitised channels'*(16). With hindsight, the banks' reliance on innovation and funding in the wholesale and securitised markets damaged their financial performance (8). The bank claims that they did not increase their risk-taking: *'Even though mortgage balances have grown significantly, we have not increased our appetite for risk'*(16). *'Northern Rock is a well-controlled, risk averse business that continues to adopt a* *prudent stance in the management of risk'*. This statement contradicts Shin's statistics, where he has shown that Northern Rock's leverage on total equity has been above 1:20 since 1998(17). In fact, leverage on total equity was 1:40 by December 2007. This is a very high leverage ratio even when compared to US investment banks, which on average had a leverage ratio of 1:25 to 1:30 in 2007(17). It is therefore beyond doubt that Northern Rock adopted a risky and highly leveraged business model. The Northern Rock is made up of 8 non-executive directors and 3 executive directors at 2004. The Annual Report boasts of the commercial and banking expertise of its non-executive directors. Yet, it is clear that even with an overwhelming majority of non-executive directors, the board failed to monitor risks properly. Growth is a clear goal of Northern Rock board and it is mentioned 35 times in the 2005 Annual Report. Yet the growth was stretching beyond its deposit base and the bank had to rely heavily on wholesale and securitised funding(18). A fundamental error made by Northern Rock was that it assumed house prices would increase forever. This is a dangerous assumption since Northern Rock was a prolific lender of 100%-125% loan to value mortgages. The board failed to consider the risk of falling house prices and a contingency plan to deal with the matter. Choudhry blamed the CEO, Adam Applegarth for the bank's growth strategy. It was a failure of board judgement that they did not consider house prices will fall at some point(18).

Northern Rock started to experience severe financial difficulties in the summer of 2007 when the sub-prime market affected the wholesale funding market. As a result of this, the tone of the annual report of 2007 is markedly different to previous years. Its mission statement has been replaced by the government's priorities: to protect UK taxpayers, promote financial stability and protect consumers. This is because Northern Rock was put unto temporary ownership of the Treasury on 22th February 2008. 2007 year has been a testing time for the bank and the word 'difficult' has been used 13 times in the 2007 Annual Report(19). The Board of Directors met 35 times in 2007 compared to 11 times in 2004-2006, indicating that there were serious issues to discuss. According to Grant Thornton's Corporate Governance Review of 2012, the average number of board meetings amongst FTSE 350 companies is 8.5 per year(20). It is remarkable that the Risk Committee only met 4 times in 2007 when it is their responsibility to monitor and review major risks affecting the bank. 2008 is a mixed year for Northern Rock. While they managed to repay some of the government loan, they continued to suffer serious losses due to external factors such as falling house prices and rising arrears(21). The Board met 38 times in 2008 and the Risk Committee met 7 times during the same year. This is clearly a response to the difficult circumstances the bank faced during that period.

Transparency is a fundamental aspect of good corporate governance. Governance and management complement each other. Good management maintains a fine balance between a wide range of products (which requires innovation) and maintaining a minimum standard. As seen above, Applegarth's risky growth model, combined with the failure to understand all the potential risks involved in securitisation produced a dangerous veil of normality. Few, including the FSA, fully understood the risks involved with the complex financial products and system. Northern Rock obtained 40% of its funding from a Structured Investment Vehicle called Granite, which had £50 billion worth of mortgages(22). Mortgages are considered by the Basel II Accord as low risk assets. Granite was an off-shore vehicle based in the Channel Islands and is thus unregulated for capital purposes(23). Northern Rock was thus under the radar for 40% of its funding. There is a lack of transparency at Northern Rock in their Annual Report regarding Granite. Information regarding Granite merely consists of £17.8 billion raised through a vehicle and amounts of securitised assets. Adam Applegarth claimed that it was actually its 'good credit quality of assets' and wide range of assets which did not require much insurance cover(24). In his view, there was transparency at Northern Rock.

There was also little accountability with the Board. The House of Commons Treasury Select Committee summarised Northern Rock's position below:

'The high-risk, reckless business strategy of Northern Rock, with its reliance on short- and medium-term wholesale funding and an absence of sufficient insurance and a failure to arrange standby facility or cover that risk, meant that it was unable to cope with the liquidity pressures placed upon it by the freezing of international capital markets in August 2007. Given that the formulation of that strategy was a fundamental role of the Board of Northern Rock, overseen by some directors who had been there since its demutualisation, the failure of that strategy must also be attributed to the Board. The non-executive members of the Board, and in particular the Chairman of the Board, the Chairman of the Risk Committee and the senior non-executive director, failed in the case of Northern Rock' (24).

The Treasury Select Committee spread the blame amongst the non-executive directors of the Board, Matt Riley (Chairman of the Board) and Sir Derek Wanless (Chairman of the Risk Committee). Authors have highlighted Adam Applegarth's role in being responsible for pursuing a risky growth model(18, 25, 26). Dowd went so far as listing Applegarth as the winner of the major culprits of corporate accountability(25). He stated that the senior executives at Northern Rock denied there was anything wrong with the business model while admitting that they did not undertake stress-testing properly. Dowd compared this with the captain of the Titanic, who assured that everyone was fine until the ship was about to hit the iceberg (25). In an era where bankers' reputation is severely attacked, it is important that trust is restored amongst the public. In the Reith Lecture series of 1st May 2002, Professor Onora O'Neill expressed her views on how we can trust the media. Although her views are not directed at financial institutions, her philosophy of better communication to improve transparency is welcomed. Better transparency and accountability are not about inundating the public with information. Nor is excessive regulation the panacea to failures in governance. In her conclusion, Professor O'Neill said that: *'If we want to avoid this unfortunate spiral [of a crisis of trust] we need to think less about accountability through micro-management and central control, and more about good governance more about limiting deception. If we are to restore trust we shall have to start communicating in ways that are open to assessment'*(27). Banks should engage better with shareholders, communicate frequently and co-operate in an open manner. Northern Rock failed to communicate with shareholders in times of crisis. Shareholder engagement is an important area of corporate governance and this will be discussed in chapter ten of this paper.

Northern Rock's mission statement up till 2006 was to deliver value for customers and shareholder through excellent products, efficiency and growth. It is clear that Northern Rock went too far in favour of financial innovation and range of products at the expense of maintaining checks and balances. Liquidity is the main culprit at Northern Rock. Although it was solvent, its assets were mainly illiquid due to the reliance on wholesale funding. This view is confirmed by Ratnowski and Huang, who conducted empirical research into 72 of the largest commercial banks in OECD countries during the financial crisis of 2007(28). Their research revealed that Northern Rock had very weak levels of capital and liquidity at the end of 2006. It was also 28.7% reliant on retail funding in the same year. Ratnowski and Huang concluded that Canadian banks were more resilient than other OECD banks because Canadian banks were more reliant on retail funding and the Canadian regulatory framework discouraged excessive risk-taking(28). Looking at their results, Northern Rock and HBOS relied the least on retail-funding (28.7% and 41% respectively). HSBC for example, had a

58.7% reliance on retail funding. Therefore, Northern Rock failed to manage its liquidity and funding structure properly.

The Royal Bank of Scotland

The Royal Bank of Scotland (RBS) started to face financial challenges approximately in the summer of 2008, a year later than Northern Rock. Banks are interconnected and arguably RBS's failure to control risks is a contributing factor to the part-nationalisation of the bank. Therefore, there are similarities between the demise of Northern Rock and RBS such as global regulation of capital. The FSA conducted a helpful review of RBS's failure in 2011(9). As is common with analysing failures of any event, many factors play a role. The FSA; global regulations; poor regulation and supervision as well as wholesale funding all contributed to the downfall of RBS. According to the FSA's report into the failure of RBS, there are three main corporate governance failures. First, the capital ratio of RBS was wholly inadequate. The RBS board failed to supervise and monitor the capital position. The Basel II Accord had two major weaknesses. First, it used a complex set of regulations to monitor the capital position of commercial banks only. The capital position of investment banks and hedge funds was not monitored(29). Secondly, the Basel II Accord allowed banks to implement their own risk models. Benink and Kaufman (cited in 29 p. 8), this is similar to *'putting the inmates in charge of the asylum'*. The Basel III Accord should have been implemented earlier since it is more conservative and asks banks to hold more capital, giving more buffer to absorb losses. Secondly, the takeover of ABN Amro was a costly mistake. It has been described as *'the wrong price, the wrong way to pay, at the wrong time and the wrong deal'*(9). RBS paid the takeover of ABN Amro by debt rather than equity. This seriously weakened the liquidity of RBS. Together with a weak capital ratio already, this dangerous combination left the bank in a vulnerable position. Finally, the board's failure to manage and govern the bank was a factor to its downfall. Many banks in the UK were affected by the financial crisis and systemic risks but some performed better than others. Good corporate governance practice therefore plays a crucial role in guiding a company through challenging situations.

Up until 2007, the capital ratio of RBS was adequate(28). It met the 8% minimum requirement of Basel II. It had a total capital ratio of 11.2% and a tier 1 capital ratio of 7.3%.

Both are above the Basel I and II requirements(9). Table 1 below shows the average Tier 1 capital ratios of RBS and five other UK banks between 2004-2009.

Name of bank	**Tier 1 Capital ratio 5 year average (%)**
Royal Bank of Scotland	8
HSBC	8.8
Barclays	8.8
Lloyds TSB	8.5
HBOS	7.2
Northern Rock	-18.7

Table 1: Average Tier 1 capital ratios of UK banks between 2004-2009
Source: Annual reports and author's calculations

The scene changed when towards the end of 2007, RBS pursued a 'capital efficiency' policy. The bank adopted a light capital ratio, which was only worsened by the debt purchase of ABN Amro in October 2007. Capital is expensive. In the CEO's words, *'we don't like carrying more capital than we need to. You've heard me before on the subject of building up war chests and carrying; that's not the way we would wish to operate at all'*(9). With hindsight, the Basel III Accord revealed that RBS did not maintain the required 9.5% common equity Tier 1 capital(9). The FSA calculated that RBS's common equity capital ratio was only 2% at the end of 2007(9). Hindsight also revealed that the FSA's call for a more rigorous capital adequacy regime in early 2008 was too late. Even with RBS's rights issue of

£12.2 billion in April 2008, the bank was still under the absolute minimum common equity Tier 1 capital level. When compared to RBS's peers, its total capital ratio between 2004-2008 was average but its Tier 1 capital ratio was low until June 2008. The low capital buffer is combined with a high trading risk exposure at RBS(9). The ABN Amro takeover doubled the bank's trading book assets. Only £2.3 billion of core Tier 1 capital was held to cover potential trading losses. In 2008, £12.2 billion of losses resulted just in credit trading.

Although inadequate capital was a major problem at RBS, it was a liquidity run which triggered serious challenges to the bank. Up till September 2007, RBS was still financially sound. It did not encounter any problem raising debt for the takeover of ABN Amro. RBS however, relied heavily on overnight funding in comparison to its peers(9). At 11 September 2007, RBS had almost 65% of overnight funding when the average is 35%. By the end of December 2007, RBS's short-term wholesale funding gap was the second largest amongst its peers. When the wholesale market dried up due to the sub-prime crisis, RBS suffered a liquidity run and required government assistance of £45.5 billion equity. The FSA once again tried to adopt a robust liquidity policy, as with the capital regime but it was too late. This is demonstrated by using the new Basel III Liquidity Coverage Ratio. RBS would need between £125 billion- £166 billion of high quality liquid assets to comply with the requirements if Basel III was implemented.

Kemal(30) used accounting ratios to analyse the financial performance of Royal Bank of Scotland in Pakistan after the merger with ABN Amro. He analysed their financial statements for four years (2006-2009) by using 20 vital ratios. The results show that the financial performance of RBS in the areas of profitability, liquidity, assets management, leverage, and cash flow has been fine before the merger. The merger failed to improve the financial performance of RBS. The FSA Report confirmed that the ABN Amro merger with RBS contributed to the latter's failure globally. The merger was the biggest in banking history(9). The then chairman of RBS said that the merger was a 'bad mistake'(9).

The FSA concluded that there are four reasons why the merger was an error. First, it increased RBS's exposure to risky trading assets. Secondly, the purchase was funded by debt which weakened the bank's liquidity and capital ratios. It thus increased RBS's reliance on short-term wholesale funding. Thirdly, RBS did not foresee the problems regarding capital requirements if ABN Amro did not receive approval for its Basel III credit risk models. Finally, the complexity of the merger combined with RBS's sole responsibility of the entire target company during the restructuring stage exposed the bank to greater downside risks. Due diligence was inadequate and limited information on ABN Amro increased market concerns(9). The due diligence process consisted of 'two lever arch folders and a CD'(9). RBS justified the limited amount of due diligence by explaining that the merger was hostile: *'We got bits and pieces of information but fundamentally it was hostile. There's the issue of did we do sufficient due diligence. Absolutely not. We were not able to do due diligence…that was part of doing a hostile acquisition'*(9). The FSA submit that RBS was too confident and complacent after the bank's successful acquisitions in the past, such as the acquisition of NatWest. In light of this background, it was submitted that RBS went ahead with the hostile acquisition of ABN Amro without analysing the risks properly. Although RBS had 9 formal board meetings and 20 ad hoc board meetings discussing the ABN Amro merger(31), the FSA argue that the RBS board failed to undertake a critical analysis of capital and liquidity risks. Board meeting minutes revealed that the CEO informed the board that *'execution risk would be high'* and that *'any bid for [ABN Amro] and subsequent integration would be more difficult than previous transactions'*(9).

Failure to analyse key risks was a major strategic error by RBS(9). The above paragraphs have demonstrated that the merger with ABN Amro was a *'critical strategic error'*(9). Evidence from the FSA's Review Team also revealed that the lack of strategy in the growth period of 2004-2007, prior to the acquisition of ABN Amro is problematic. There were three main weaknesses: insufficient time dedicated to discuss key risks; insufficient discussion of the relevant markets and inadequate number of staff who can think strategically(9). RBS had many employees who could implement strategy but there were few who could lead and identify the right strategy. RBS's priorities were growth and profits. These words were mentioned 113 and 19 times in the Annual Report of 2005(32). There is nothing wrong with growth and profits but this must be combined with a clear review of the strategic risks and options. RBS failed to do this. It ignored the potential impact of a strategy on its balance sheet.

Another failure in corporate governance relates to the boardroom culture. There is evidence from a memorandum of RBS's Head of Group Internal Audit to the RBS Chairman in July 2009 that the Group Executive Management Committee was not working well(9). The most important concern is the bullying nature of board discussions. The dominant personality of the CEO (Sir Fred Goodwin) made it difficult for board numbers to be critical or challenge board decisions. A healthy boardroom should encourage open, critical and constructive debates about strategy and risks. As a result, there was a negative atmosphere at the upper management level and the team was unable to work well. The agenda of the Group Executive Management Committee placed too much emphasis on performance targets, again reflecting the bank's priority on growth and profits. Another criticism is that the CEO delegated too many roles and responsibilities to others and did not monitor the relevant staff. The CEO was also criticised for not appreciating the risks in RBS's syndicated loans market and the increasing amount of risks across the bank. Evidence from Johnny Cameron, the Chairman of RBS's Global Banking and Markets is crucial. He said that:

'There was a view among some shareholders that the CEO did not fully appreciate the large, single name risks from RBS's rapidly growing exposures in the syndicated and leveraged loans markets; and the growing accumulation of risks across the Group. I don't think, even at that point, I fully, had enough information. Brian [Cowe] may have thought I understood more than I did…And it's around this time that I became clearer on what CDOs (Collateral debt obligations) were, but it's probably later'(9).

RBS continued to issue CDOs in 2007 when market conditions deteriorated. The FSA held that this action is not unreasonable since the quality of the CDOs was excellent according to credit rating agencies. The FSA did not find that RBS amount a breach in relation to management controls or risk assessment systems. However, the FSA highlighted a number of corporate governance concerns. First, the RBS board did not formally agree a Group Liquidity Policy. Secondly, the board focused too much on reviewing past and current risks. It did not predict or foresee the relevant future risks. Attendance by the Group Chief Risk Officer on the Group Executive Management Committee was initially poor due to the CEO's objection. The objection is because the Group Chief Risk Officer reported to the Group Finance Director, who attended the meetings(9). It was only in April 2008 when the Group Chief Risk Officer became a full member of the Group Executive Management Committee. This is a serious mistake since the Group Chief Risk Officer is a very important member of staff at the bank, especially during the growth period of 2004-2007(9). Without his attendance, the other members were not informed of potential risks and policies. Evidence from the RBS Group Internal Audit Report 2008 showed that members of the Group Risk Committee (not a committee of the board) did not attend meetings regularly. The Group Risk Committee members should discuss potential risks and solutions. Instead, members reviewed past data and approved policies where appropriate. Further, there is no evidence that the members referred any potential risk to the Group Executive Management Committee(9). Therefore, even if potential risks were identified, they remained at the low level of RBS.

A review of the annual reports of RBS between 2004-2009 produced little information for the readers, primarily because the annual reports are rather generic. Information on internal controls, disclosure controls and procedures are vague and standardised. The bank's mission statement is 'Make It Happen'. This seems to reflect the positive, 'can-do' attitude which the bank is keen on. Nevertheless, evidence shown earlier revealed that the board was too confident and complacent with its past records which led to the mistake of the ABN Amro acquisition. The annual reports did reveal interesting information about board composition and size. First, the RBS board is 'male and pale'. Diversity is lacking since there is only one woman on the board since 2004 and there are no directors from ethnic minority background. There were 16 directors (8 executive and 8 non-executive) in 2004 and 14 directors (9 executive and 5 non-executive) in 2005. In 2006 and 2007, there were 17 directors (7 executive and 10 non-executive). In 2008, there were 10 directors (4 executive and 6 non-executive). Board size was rather large with 16 directors in 2004 in comparison to the average board size of 11 directors with the FTSE 100 companies(20). The FSA questioned the board size in its report and the effectiveness of the board of directors when it is too big(9). The RBS board had 9 board meetings and 20 ad hoc board meetings in 2007 to discuss the ABN Amro merger. In 2009, the board held 10 formal meetings; 39 ad hoc meetings to discuss the Asset Protection Scheme; 4 additional meetings to discuss the bank's Group Interim Management Statements and Asset Protection Scheme. The bank's Remuneration Committee held 16 additional meetings to discuss the sensitive issue of executive compensation. RBS, together with Lloyds and HBOS, received £37 billion on 13th October 2008 after the bank suffered its biggest annual loss in UK corporate history of £24.1 billion(33). The Asset Protection Scheme played a central role in restoring confidence in the UK's biggest banks by providing protection against future losses on their riskiest assets. Banks received protection for a proportion of their balance sheets so that the healthier core of their commercial business can continue to lend to creditworthy businesses and households. In return for access to the Asset Protection Scheme, banks had to pay a fee and enter into legally binding agreements to increase the amount of lending they provide to homeowners and businesses. The RBS board met frequently during this period but as we saw earlier, attendance of the Group Chief Risk Officer at the Group Executive Management Committee and general attendance of the Group Risk Committee were poor. Even if risks were identified, they were not always referred upwards.

At the pinnacle of the RBS management team is the CEO. Although the FSA Enforcement Team did not have sufficient evidence to bring any action against the then CEO, Fred Goodwin, it is clear that there were deficiencies at RBS and Fred Goodwin's dominant and aggressive personality played a role in the downfall of the bank. Growth and profits were prioritised under his leadership but these were not backed up by robust risk assessments or monitoring(9). There was a change in strategy as shown in the 2008 RBS Annual Report, where the bank *'aim to rely less on volatile, unsecured wholesale funding'* and a *'strategic understanding of our businesses and a focus on long-term, quality profitability'*(34). This change and focus on more cautious funding, strategy and long-term profitability are encouraging. With 82% of the bank's ownership in the government, RBS need to exercise caution with its strategy since there is a heavy stakeholder interest in the bank. Further, RBS was fined £87.5 million in February 2013 for breaching section 206 of the Financial Services and Markets Act 2000 in the LIBOR scandal(35). LIBOR is the London inter-bank lending rate. It is a benchmark rate at which banks lend to each other in the overnight market. RBS committed a number of breaches. Individual traders colluded with other firms and panels in manipulating the Japanese and Swiss franc LIBOR submissions between 2006-2010(35). At company level, RBS did not have adequate internal controls and processes to monitor risks associated with derivatives trading. Further, RBS attested in 2011 that they had adequate systems in place when they did not(35). Stephen Hester, the current CEO of RBS, admitted that there is a cultural problem in banking and that it will take a generation for cultural changes to take place in the banking sector(36). Bankers must take the lead to implement corporate governance changes: they must lead by example and public sentiment demands it.

Lloyds Banking Group

Lloyds Banking Group is the result of a merger between Lloyds TSB and HBOS in January 2009. Lloyds Banking Group is the parent company of Lloyds TSB; Lloyds TSB Scotland Plc. and Halifax Bank of Scotland. They were founded by John Taylor and Sampson Lloyd. Sampson Lloyd was from a Quaker family. Quakers' principles and values align better to the stakeholder model than shareholder model in corporate governance. Profit was not an end in itself. Once profit was made, the Quakers would ensure that employees and the local community benefits from it via health protection schemes, literacy classes and voluntary work. Lloyds focused on retail banking and small corporate market. They held onto the 'originate-to-hold' policy without venturing into the complicated world of securitisation. They managed risks tightly and aimed to deliver consistent returns to shareholders. By 2000 however, the investment banking model lured most bankers. The conservative model relied upon by Lloyds was deemed old-fashioned. Lloyds followed the other big UK banks and ventured into the wholesale money market.

HBOS was formed in 2001 when the Halifax Plc. and the Bank of Scotland merged. HBOS was identified as a competitor to the big four UK retail banks. It was also the UK's largest mortgage lender. The business model adopted by HBOS and the takeover of HBOS by Lloyds in January 2009 deserve close examination in this case study. It has been submitted that the true reason for the failure of HBOS was its corporate division's lending on the wholesale market(37). The takeover of HBOS (the weaker bank) by Lloyds has been described as a 'shotgun marriage' by Paul Moore, ex-Head of Regulatory Risk at HBOS between 2002-2005(38). Competition rules were waived in the takeover of HBOS by Lloyds due to the need to restore public confidence. Sir John Vickers, the author of the Vickers' report on banking reforms, is of the view that the waiver was a 'policy mistake'(39). The study will rely on Paul Moore's interview, the Parliamentary Commission on Banking Standards' report, annual reports of HBOS, Lloyds TSB and Lloyds Banking Group from 2004 onwards for the case study. The Treasury Committee will appoint advisors to oversee the FSA's report into the failure of HBOS. The public can only find out more about the failures of banks through government reports. Andrew Tyrie, Chairman of the Treasury Committee said that the report *'must be comprehensive, covering the reasons for, and consequences of, both the Lloyds/HBOS merger and the earlier Bank of Scotland/Halifax merger'*(40).

The Parliamentary Commission on Banking Standards Report of 2013 is a thorough investigation into the failure of HBOS. In the report, it said that: -

'HBOS had no culture of investment banking; if anything, its dominant culture was that of retail banking and retail financial services more widely, areas from which its senior management were largely drawn. Whatever may explain the problems of other banks, the downfall of HBOS was not the result of cultural contamination by investment banking. This

was a traditional bank failure pure and simple. It was a case of a bank pursuing traditional banking activities and pursuing them badly'(10).

HBOS was not an investment bank but it pursued an aggressive and risky business model. HBOS increased its corporate lending by 50% between 2006 and the end of 2008, a period when other UK banks were being more conservative:

'HBOS set a strategy for aggressive, asset-led growth across divisions over a sustained period. This involved accepting more risk across all divisions of the Group'(10).

The culture at HBOS was 'brash', too confident and believed that it was a conservative bank when it was not(10). Liquidity provided the setting for failure but it did not lead to the demise of HBOS. Instead, the fundamental problem was solvency. Losses were sustained in three divisions of HBOS and poor asset quality aggravated the solvency position:

'The problems of solvency were a direct consequence of the strategy set by the Board and the failure of controls on the practices that were fostered by its commitment to an asset-led, high-risk approach to growth'(10)

The Parliamentary Commission on Banking Standards concluded by stating that without government intervention, HBOS would have been insolvent.

The article by Ellis and Taylor provides an interesting account of the culture at HBOS from Margaret Taylor, an ex-employee of HBOS who is also a political activist(37). Taylor has three reasons on why HBOS went wrong: first, the incentive structure has changed from a simple pay package to individualised, performance driven pay. Secondly, deregulation in the 1980s encouraged retail organisations to expand into banking. This led to a more sales driven approach in banking and increased emphasis on marketing. Gardener, Howcroft et al (1999) concur with this view. In their paper, they conducted a case study into the evolution of retail banking in the UK. They found that since the mid-1970s, banks became more market-orientated. Promotion and marketing became more important(41). Finally, technological advances have replaced human labour(37).

Modern banking became more reliant on sophisticated products and processes. HBOS created a large portfolio of residential mortgages exposed to the sub-prime market from the Halifax. This was not apparent to staff at the Halifax initially. Staff had to:

‘*read the business pages to know that. This wasn’t the message that was coming to staff from the guy who was in charge of the company [Andy Hornby], who Bank of Scotland staff had never trusted and many didn’t like because he wasn’t a banker. He didn’t come from a banking background, he’d worked for ASDA, tended to have a strategy of stack them high and sell them cheap and wanted a big market share. Many people blame him personally for bringing the company down’(37).*

Paul Moore agrees that leadership at the top of HBOS was weak. He believes however, that it was Sir James Crosby, the ex-Chief Executive of HBOS, who was the principal person to blame for the bank’s ‘grow assets at all costs’ strategy (42).

The boardroom culture at HBOS was unhealthy since the non-executive directors were not encouraged to challenge decisions. Lord Stevenson, former non-executive chairman of HBOS, revealed in his evidence to the Parliamentary Committee on Banking Standards that he and the other non-executive directors did not challenge the ‘aggressive expansion strategy’ in the boardroom(11). He admitted that: *‘As a non-executive chairman, I did not experience the executive challenge … first hand’*(43). Another non-executive director of HBOS, Charles Dunstone, was open about his inexperience in banking. Although Mr Dunstone is a successful businessman and founder of the Carphone Warehouse, Andy Hornby appointed him as Chairman of the Retail Risk Control Committee at HBOS since they were close friends. Paul Moore however, had reservations about Charles Dunstone’s knowledge and experience in banking. According to Paul Moore, Charles Dunstone *‘himself admitted to me and my colleague one day words to the effect that he had no real idea how to be the Chairman of the Retail Risk Control Committee!’*(42) Incompetence can be seen at the company level as well. HBOS also lost £3.6bn in the Australian market even though Australia was affected to a lesser degree than the UK in the financial crisis. Sir James Crosby has admitted that *‘the figures were an awful result . . . I do think that with the benefit of hindsight it was incompetent’*(11). He also admitted in the Parliamentary Commission Banking Standards Report that the non-executive directors’ expertise in banking was insufficient at HBOS: the composition of the board at HBOS was not appropriate for a *‘business concentrating entirely on banking’*(10).

Poor communication from senior level to junior staff was prevalent at HBOS(37). During the financial crisis, the bank staff were constantly reassured that HBOS was in a robust financial position and that the bank’s assets were strong(37). This false reassurance, combined with the lack of meetings between senior management and junior staff led to anger and frustration. Eventually, fear dawned upon the bank staff. They were worried of losing their jobs and felt isolated from the lack of transparency. This is a shame since employees are important stakeholders of an organisation. Regular meetings and open communication are required to keep employees informed and maintain staff morale. Compared to HBOS's approach to institutional investors, more needs to be done on communication with employees. Annual reports of HBOS showed that between 2004-2009, the bank had a comprehensive programme of meetings and dialogues with institutional investors(44-49). When Lloyds took over HBOS in 2009, annual reports of Lloyds Banking Group from 2009-2011 revealed that the regular shareholder engagement continued(50-52).

It is often difficult to obtain a true picture of a bank's culture from annual reports alone. Nevertheless, it is interesting to note that HBOS had 17 board meetings in 2008 compared to 10 in previous years (2005-2007). Lloyds Banking Group held 28 board meetings in 2009. 2008-2009 is a crucial period due to the financial crisis and the takeover of HBOS. Thus, more meetings were held to deal with the unexpected circumstances. Apart from these facts, there is very little information about corporate governance of HBOS, Lloyds or Lloyds Banking Group that we can learn from the annual reports. More beneficial is the information given by Paul Moore, both at the Treasury Select Committee and my interview with him. Paul Moore said: *'I strongly believed that the real underlying cause of all the problems was simply this - a total failure of all key aspects of governance. In my view and from my personal experience at HBOS, all the other specific failures stem from this one primary cause.'*(42) In particular, he submitted that the executive directors were rarely challenged or adequately monitored by non-executive directors, the FSA, shareholders and auditors. HBOS had adequate numbers of non-executive directors, averaging 7 or 8 on the board (44-48). Naturally, it is the quality, experience and knowledge of non-executive directors which matter. During the financial crisis, the evidence shown so far revealed that the executive directors faced little challenge or opposition, even when the sales culture was going too fast(42) (37). Paul Moore described that HBOS staff were *'being forced to sell things; sell credit; sell mortgages; sell insurance products that were simply not in the best interests of the customer'*. The Head of Risk in the division said to Paul that: '*they [HBOS directors] pay no attention to risk management here at all. The only thing that counts is sales and you know, they are animals around here'*(38). From 2004, there is evidence that at HBOS, *'leadership* *and focus on risk matters has had no priority'; 'sales regarded as more important than anything else'* and *"risk not seen as a core business imperative or competency'*(53).

Wisskirchen, Vater et al(54) support the argument that HBOS pursued a sales policy. Their main submission is that many retail banks adopted an innovative and short-term sales approach since long-term growth and profitability were difficult to attract new customers. They mentioned in particular, the innovative approach HBOS adopted. In order to compete with the other major UK retail banks, HBOS advertised heavily their simple yet innovative products. An example is an interest-bearing current account which paid more interest on deposits than any other account on the market. HBOS trained all its customer assistants on helping new customers to transfer their bank details and accounts. HBOS then rewarded its customer assistants who achieved their sales targets(54). HBOS managed to increase its overall share of current accounts from 9% to 14% between 2002-2006(54).

Wisskirchen, Vater et al's article revealed that most retail banks are aware that developing a strong customer relationship is very important. The authors used a study in 2004 by Bain & Company which showed that UK banks performed worst in customer relationships. There is therefore, significant area for improvement in this field. Although Wisskirchen, Vater et al provide a more sympathetic view of HBOS's sales policy than Paul Moore, the fact that customer assistants are rewarded for hitting their sales targets correspond with Ellis and Taylor's submission that individualised, performance driven pay is one of the reasons why HBOS failed(37).

The takeover of HBOS by Lloyds TSB created a new public interest ground for competition rules to be waived. In normal circumstances, a merger of new major banks would breach competition rules. Although HBOS was solvent, it had severe liquidity problems. Fear and lack of confidence in the financial sector also contributed to the establishment of the public interest ground. On 16th September 2008, the share price of HBOS fell by 40% after Lehman Brothers collapsed. Therefore two days later, the takeover was agreed. Parliament had to revise the Enterprise Act 2002 to include a new public interest consideration of 'the interest of maintaining the stability of the UK financial system' (Section 58(2)(D) Enterprise Act 2002). The government chose Lloyds TSB as the purchaser for two reasons. First, Lloyds was financially robust in comparison to other banks during the financial crisis. Secondly, merging with Lloyds would not have a European dimension so it is strictly subject to UK merger legislation(55). The new Lloyds Banking Group own 30% of the current account market and 33% of the mortgage account(55).

Was the forced merger the right decision? It is important to remember that the background to this forced merger was one of serious panic in the financial sector. The UK government nationalised Northern Rock in February 2008 and Bradford & Bingley in September 2008. In the US, the Federal Reserve Bank bailed out Bear Stearns but Lehman Brothers collapsed, sending seismic shockwaves across the financial sector. Due to the inter-connectedness of banks; fear of systemic risks and fear of lack of confidence in the economy, it can be argued that the forced merger between HBOS and Lloyds TSB was necessary and in the public's interest. On the other hand, Sir John Vickers argued that the forced merger was a policy mistake (39). His submission is that the merger only temporarily restored public confidence. Lloyds Banking Group announced a pre-tax loss of £10.8 billion for HBOS. In August 2009, it announced a further £4 million loss. The UK government had to inject £21 billion to bail out HBOS(56). In light of the costs, Sir John argued that the government should have nationalised HBOS. In short, the forced merger was short-sighted. Taxpayers still own 41% of shares in Lloyds Banking Group. Lloyds Banking Group reported a combined businesses profit before tax of £2,685 million in 2011 (2010: £2,212 million)(52).

The FSA has since taken enforcement action and censured HBOS's corporate division for 'very serious misconduct' during 2006-2008. In March 2012, it announced that HBOS failed to comply with Principle 3 of the FSA's Principles for Businesses. Principle 3 states: *'A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems'*(57). The reason is that HBOS pursued an aggressive growth strategy even in the period of 2006-2008 when the other UK banks scaled back their lending to corporate borrowers. More importantly, the FSA held that HBOS had a culture of focusing on profit at the expense of assessing risks properly. Therefore, it felt that a public censure is appropriate as a 'name and shame' mechanism. The Parliamentary Commission on Banking Standards Report on the failure of HBOS is clear that Andy Hornby, Sir James Crosby and Lord Stevenson should be banned from being bankers: -

'The weaknesses of group risk in HBOS were a matter of design, not accident. Responsibility for this lies with Sir James Crosby, who as Chief Executive until 2005 was responsible for

that design, with Andy Hornby, who failed to address the matter, and particularly with Lord Stevenson as Chairman throughout the period in question.'(10)

Sir James Crosby resigned from Bridgepoint, a private equity firm on the same day(58). It is encouraging to see that the Parliamentary Commissions Report has led to a positive and immediate effect.

Barclays Bank Plc

Barclays Bank was founded by two Quakers, John Freame and Thomas Gould, who began trading as goldsmith bankers in 1690. Frame's son-in-law, James Barclay, became a partner in 1736. Barclays Bank acquired other UK banks such as London, Provincial and South Western Bank between 1900 and 1990. Innovation was apparent at Barclays in the early days. It is the first bank to install computers into branches and to use cash machines. It is also the first bank to use plastic bank card with the introduction of the Barclay card in 1966(59). Innovation continued at Barclays when Bob Diamond joined the bank as its CEO in 1996. Bob Diamond has considerable experience in investment banking and Barclays was the last British bank to compete in the global investment banking market. Financial innovation is found in the originate-to-distribute model and securitisation, both used in investment banking. Under Bob Diamond's leadership, Barclays Capital became the most profitable arm of Barclays. At its peak, it generated 90% of the bank's profit(60). Due to its focus on investment banking, financial growth is very important to Barclays. This is evident from its Annual Report between 2004-2009. The word 'growth' was mentioned 155 times in 2004(61); 190 times in 2005(62); 205 times in 2006(63); 231 times in 2007(64); 40 times in 2008(65) and 172 times in 2009(66).

The financial crisis of 2007-2009 affected Barclays, like the other major UK banks. The more risk-averse tone in the 2008 Annual Report reflects the impact the crisis has had on the bank. Unlike the other major UK banks, Barclays resorted to private finance to weather the financial crisis. On 25th June 2008, Barclays announced a share issue of £4.5 billion to strengthen its balance sheet. Later on 31st October 2008, Barclays announced plans to raise additional capital of up to £7.3 billion. The Qatar Investment Authority, rather than existing shareholders of Barclays, provided the capital injection. On 13th January 2009, Barclays Bank cut approximately 2,100 jobs globally across its investment banking and wealth management branches. In August 2011, 3,000 jobs were cut at Barclays. In January 2012, the bank cut 422 IT jobs as part of its restructuring exercise. This is the cost of competing with global investment banks under Bob Diamond's leadership. Bob Diamond's strategy is far removed from the Quaker's values of social responsibility, honesty and integrity.

Barclays have been in the limelight of media attention since the financial crisis for two main reasons: bankers' remuneration and the LIBOR scandal. Bankers have been described as greedy and reckless in the press(67), (68). It is important to note that not all bankers are highly paid. Therefore, the criticism levelled against bankers is restricted to those of senior management. Nevertheless, Bob Diamond's pay package has been criticised. In the Treasury Select Committee, John Mann, a Member of Parliament, described Diamond's bonus as 'extraordinary greed'(69). In 2011, Bob Diamond received a total pay package of £17 million(70). This is higher than the CEO's pay package of RBS or Lloyds Banking Group. In 2010, Bob Diamond received a cash bonus of £6.5 million in addition to a base salary of £250,000(71). Bob Diamond's base salary was frozen at £250,000 for several years. His cash bonuses for 2009 and 2008 were £6.8 and £10.7 million respectively(65, 66). It is important to note that Bob Diamond waived his bonus in 2008 and 2009 due to public pressure. The average bonus amongst UK bankers is £12,000 in March 2011(72). It thus appears that the bonus element of Bob Diamond's package is very high.

The literature on executive compensation is vast and academics are inconclusive on whether executive remuneration led to distortion of incentives or whether there was too much emphasis on short-termism. Gregg, Jewell et al(73) analysed the pay in the UK financial industry. They concluded that whilst pay is high in financial organisations, the cash-plus-bonus pay-performance sensitivity of financial firms is not significantly higher compared to other industries. Their results showed that RBS had the highest total compensation in 2000 amongst the big four UK banks. By 2006 however, Barclays had the highest total compensation. Gregg, Jewell et al are not convinced that the incentive structure in bankers' pay led to excessive risk-taking(73). One must note however, that their results did not include equity incentive payments. In the UK, the FSA and Sir David Walker criticised the role of non-equity incentive payments for not relating to long-term profitability. Perhaps this explains the focus on cash bonus in Gregg, Jewell et al's study. Bebchuk et al disagree with Gregg, Jewell et al's study. Bebchuk et al produced a case study into the role of executive compensation at Lehman Brothers and Bear Stearns(74). Their results revealed that incentives at these organisations are distorted. Bankers were encouraged to take excessive risks since there was no penalty or repercussion if they make losses. Bankers had ample opportunity to cash out their shares which encouraged short-termism. Bebchuk, Cohen et al submit that changes ought to be made to remuneration packages so that they are linked to a firm's long-term results. Further, claw-back provisions should be inserted into employment contracts to act as a deterrent to excessive risk-taking. The author agrees that these are necessary since risk-taking without penalties is a licence to disaster. The absence of claw-back clauses in employment contracts means that bankers were not deterred from excessive risk-taking. Combined with excessive optimism and incomplete knowledge of the risks involved in modern banking, losses were of little concern to bankers since they were not responsible for them. The author agrees that claw-back provisions are required in bankers' employment contracts so that bankers are not rewarded for failure. Evidence from David Paterson, Head of Corporate Governance, National Association of Pension Funds at the House of Commons Treasury Select Committee revealed that the remuneration culture at banks has not changed much since the financial crisis(75). David Paterson explained that Asia and America contribute to the culture of investment banking, high salaries and private businesses. It is this culture which is not aligning to the interests of shareholders(75). Banks must change its culture from within.

Barclays failed to improve its image after the maelstrom over bonuses. The LIBOR fixing scandal exposed Barclays' bankers as dishonest, manipulative and fraudulent. Barclays, like RBS and UBS, were fined for their involvement in the LIBOR scandal in June 2012. The fine amounted to £57.5 million(76). According to the FSA's investigation, Barclays are guilty of three actions: First, Barclays started submitting false LIBOR and EURIBOR (the equivalent of LIBOR in the Eurozone) rates at the request of derivatives traders and other banks back in 2005. Staff in New York, London and Tokyo were involved with manipulating LIBOR at Barclays(77). The FSA report specifically mentioned that the false submissions were motivated by profit(78). Secondly, Barclays tried to influence the EURIBOR rates of other banks. Finally, Barclays reduced its LIBOR rate during the financial crisis in an attempt to improve the negative image portrayed by the media(78). The FSA further explained that Barclays failed in its corporate governance since the bank did not have adequate controls and processes for checking the LIBOR and EURIBOR submissions until June 2010. Senior management at Barclays failed to deal with warning signs of LIBOR submissions in 2007 and

2008. From the LIBOR scandal, it is clear that between 2005-2007, false submissions and manipulations were made primarily due to greed. Between 2007-2009, Barclays manipulated the LIBOR rate because of marketing reasons. Both of these incidents expose Barclays as a bank preoccupied with self-interests. Tracey McDermott, the acting director of enforcement and financial crime at the FSA, said that: *‘Barclays' misconduct was serious, widespread and extended over a number of years. The integrity of benchmark reference rates such as LIBOR and EURIBOR is of fundamental importance to both UK and international financial markets. Firms making submissions must not use those submissions as tools to promote their own interests’*(78). Traders discussed and shouted their requests openly at their desks. Why did no one at Barclays raise the alarm?

At Barclays, there is evidence of a culture of fear. Joris Luyendijk, a journalist for The Guardian, conducted around 70 anonymised interviews with staff working in the financial industry in 2011(79). The staff range from support administrators to bank directors and presidents. These interviews are very useful as they give the public an insight into the culture of banks in the City of London. From the interviews, Luyendijk concluded that bankers work in teams and speaking out will lead to the loss of job and identity. One interviewee said: *‘Bankers work in teams, and the ethic there is: you are with us or you're against us. Speaking out makes you vulnerable. If you have a guilty secret hidden somewhere, they'll find it and expose you. This isn't just the bonus culture. This is about tribal bonding, about belonging and sticking with your mates’*(80). Luyendijk concluded that: *‘if you had to design a working environment that encouraged short-termist conformism and discouraged whistleblowing, then the finance sector would be your blueprint’*(79). A culture of fear and conformity transcends banks. At Barclays, the fact that no one raised the alarm regarding the LIBOR scandal when there is evidence that traders knew about it suggests that there is a culture of fear in the bank. Despite stating in their Annual report of 2006 and 2007 that Barclays have ‘an annual review of the Group’s whistleblowing process’ and *‘dedicated whistleblowing hotlines and email address so that employees can talk about what has happened, or is happening, directly and in confidence’*, no one from Barclays spoke out. This is a serious weakness and must be addressed urgently, especially in light of the allegation that Barclays have been involved in rigging electricity market in California and face a potential fine of £292 million(81).

In June 2012, the House of Commons Treasury Select Committee held an inquiry into corporate governance and remuneration in the financial services sector. Barclays was one of the banks which gave evidence. It is encouraging to see that Barclays believe that they should adopt a more judgement-based approach to corporate governance(82). Barclays recognised that shaping the culture of an organisation is the joint responsibility of management and board. Barclays support the recommendations of the Walker Review(83) and have so far implemented a variety of measures regarding non-executive directors; annual re-election of directors and increasing the power of the Chief Risk Officer(82). These are all encouraging steps and it is hoped that Barclays will learn from the financial crisis and the LIBOR scandals to improve its corporate governance.

HSBC

HSBC is different to the other four banks examined in this case study because it was founded abroad, namely in Hong Kong. HSBC Banking Group started life as the Hong Kong and Shanghai Banking Corporation Limited. Its first office was in Hong Kong and the bank was set up to facilitate trade between China and Europe. In 1851, the first UK branch opened as the Birmingham and Midland Bank. In 1992, Midland bank became a wholly-owned company of the HSBC Group. HSBC has launched innovative products and services such as first direct, UK's first telephone banking system; internet banking and as the first UK lender to comply with Sharia law(84).

HSBC weathered the financial crisis of 2007 better than the other four UK banks. Its successful formula is based on three factors: first, a focus on emerging markets, especially Hong Kong, China. In 2007, 30.3% of HSBC's profits (before tax) were made in Hong Kong. 33.8% of profits (before tax) were made in Latin America and Asia-Pacific countries(85). In 2006, 23.5% of HSBC's profits (before tax) were made in Hong Kong. 23.9% of profits (before tax) were made in Latin America and Asia-Pacific countries(85). Secondly, HSBC has a balanced split of retail banking (31%) and investment banking (31%) in its equity base (86). This is important because this diversity protected HSBC better from externalities such as the freezing of liquidity in the wholesale market. Finally, there is a loyal investor base within the bank. Thanks to its loyal investors, HSBC were able to operate a successful rights issue in March 2009. This raised £12.5 billion for the bank and enhanced its capital position(87). As a result of this formula, HSBC did not require a bail-out or governmental assistance during the financial crisis of 2007. Yet, HSBC experienced difficulties at the beginning of the financial crisis. HSBC revealed huge losses at its US mortgage arm Household Finance due to subprime losses on 5th March 2007. As a result of this, HSBC had to increase its bad debt provision by 36%(88). When HSBC's competitors are criticised for their remuneration packages, HSBC survived a shareholder attack on its incentive policy, governance and performance in 2007(89). Knight Vincke, an active institutional shareholder, submitted that HSBC's incentive plan is legally void because the performance targets are misleading. Knight Vincke is however, alone in its opposition. Other shareholders were aware that HSBC's incentive plan would be changed in 2008 and were happy with the bank's governance policy. This example and the rights issue in 2009 show that HSBC's shareholders are supportive and satisfied with the bank's governance framework.

Indeed, HSBC seems to negate the author's hypotheses of a sales driven culture and that greed, recklessness and dishonesty formed part of the banking culture. HSBC annual reports are more thorough and longer than the other banks' annual reports. They are often more than 400 pages. Growth is important to any business with ambition and HSBC is no exception. At the end of 2003, HSBC embarked on a strategy named 'Managing for growth', where the focus is on evolutionary steps, not revolutionary ones(90). Its ambition was to become the world's 'leading' financial services company. Their definition of 'leading' is 'preferred, admired, dynamic, recognised for giving customer a fair deal'(90). According to the annual report of 2004, stakeholders are given high priority. There is regular dialogue between institutional investors and executives. Board composition is healthy with 15 non-executive directors and 7 executive directors. 7 board meetings were held during 2003-2004. Nevertheless, 'whistleblowing' is not mentioned anywhere in the 2004 annual report. Nor is there any information for employees to raise concerns about potential malpractice. The word 'growth' is mentioned 349 times in the report and 'profit' mentioned 495 times in the report, thus indicating that HSBC has ambitions. It is doubtful whether one can conclude that HSBC has a sales driven culture or that the bank is reckless and dishonest from this information. In 2006, the annual report again mentioned the 'Managing for growth' strategy. There were still 15 non-executive directors but 3 executive directors in 2006. With 22 directors, HSBC has a big board of directors. The FSA questioned the size of RBS's board in 2011. HSBC should therefore be aware of its board size. 7 board meetings were held in 2005-2006. 'Growth' now featured 647 times and 'profit' 463 times in the annual report(91). There was still no mechanism for raising concerns about potential malpractice. In 2009 however, the bank changed its strategy to being 'the world's local bank'. Board composition remains largely similar with 15 non-executive directors and 4 executive directors. 8 board meetings were held between 2008-2009. The most noticeable difference is that the word 'growth' was only mentioned 195 times compared to 647 in 2006. 'Profit' was still mentioned frequently in 2009, at 613 times(92).

Annual reports of HSBC seem to provide a healthy governance structure. In June 2012, written evidence from HSBC on corporate governance and remuneration in the financial services sector provides further insight of HSBC's view on corporate governance. Douglas Flint, Chairman of HSBC said that:

'We believe that the principal corporate governance role of the Board for any bank within the Group is to ensure that its bank has the right executive leadership and depth in its executive team, from HSBC Holdings itself downwards, that the balance between executive delegation and reserved powers is appropriate and that there is sufficient reliable information made available to the Board to review and challenge the performance of the executive management'(82).

The final phrase is important in light of the Mexican drug scandal. The U.S Permanent Subcommittee on Investigations conducted a hearing on HSBC in July 2012. Their report highlighted five weaknesses in anti-money laundering and terrorist financing(93) at HSBC:
'opening U.S. correspondent accounts for high risk affiliates without conducting due diligence; facilitating transactions that hinder U.S. efforts to stop terrorists, drug traffickers, rogue jurisdictions, and other from using the U.S. financial system; providing U.S. correspondent services to banks with links to terrorism; clearing bulk U.S. dollar travellers cheques despite signs of suspicious activity; and offering high risk bearer share corporate accounts'(93).

These weaknesses in anti-money laundering and terrorist financing extend the geographical network to Saudi Arabia and Russia. HSBC had significant business transactions with Al Rajhi Bank in Saudi Arabia. After the 9/11 terrorist attack, there is evidence that Al Rajhi Bank had links to financing organisations associated with terrorism. There is also evidence that the founder of Al Rajhi Bank was a benefactor of Al Qaeda(93) HSBC announced in

2005 that it would stop dealing with Al Rajhi Bank but this was reversed four months later. HSBC U.S.A initially resisted to trade with Al Rajhi Bank for two years. In December 2006 however, Al Rajhi Bank threatened to terminate trading with HSBC unless it had access to its U.S banknotes programme. HSBC provided almost $1 billion U.S dollars to Al Rajhi Bank in 2010(93). HSBC U.S.A also supplied U.S. dollars to Islami Bank Bangladesh Ltd. and Social Islami Bank, despite evidence of links to terrorist financing. HSBC also cleared $290 million in U.S travellers' cheques for Hokuriku Bank, a Japanese bank, between 2005-2008, benefiting Russians who claimed to be in the used car business(93). Ms. Irene Dorner, President and CEO of HSBC Bank U.S.A and HSBC North America Holdings, admitted in her testimony that there were gaps and weaknesses in the anti-money laundering system at HSBC(94). To rectify this issue, HSBC Bank U.S.A and HSBC North America Holdings changed its senior management team which includes Ms. Dorner as the new CEO. The Anti-Money Laundering Officer has been given more importance and access to the Board. He reports regularly to the Board and senior management about anti-money laundering issues(94). More staff were hired and trained to deal with anti-money laundering matters. This would hopefully deal with the 17,000 unreviewed alerts of suspicious activity at HSBC U.S.A(93). New Know-Your-Customer policies and improved risk controls have been implemented(94).

As a result of this investigation, HSBC agreed to pay £1.2 billion to the US regulator(95). Stuart Gulliver, the CEO of HSBC Group admitted having a weak anti-money laundering system and apologised (96). This settlement has three important implications for the bank. First, up till this scandal, HSBC survived the financial crisis with its reputation relatively intact compared to its competitors. Secondly, the huge fine is important since it indicates the severity of the matter. Finally, the settlement reveals the reckless and dishonest aspects of HSBC bank executives. According to the U.S. Department of Justice’s press release, *‘HSBC’s blatant failure to implement proper anti-money laundering controls facilitated the laundering of at least $881 million in drug proceeds through the U.S. financial system. HSBC’s wilful flouting of U.S. sanctions laws and regulations resulted in the processing of hundreds of millions of dollars in Office of Foreign Assets Control-prohibited transactions’*(97).

Money-laundering is a serious type of financial crime, so is manipulating the LIBOR rate. Although HSBC is not yet under investigation for the LIBOR scandal at the time of writing this case study, the Mexican drugs scandal has already tarnished the bank's reputation. Therefore, it is important that the board of directors, especially with its big team of non-executive directors, challenge the executive's decisions adequately. HSBC executives also need to improve its internal control mechanism to prevent such a scandal from happening again. The bank set up a Group Risk Committee following Walker's review in 2010. This is too little too late. Evidence shows that HSBC Group was aware of malpractice back in 2000(97). When HSBC Bank U.S.A questioned HSBC Group's practice of amending payments, the former was reassured that *'Group Compliance would not support blatant attempts to avoid sanctions, or actions which would place [HSBC Bank USA] in a potentially compromising position'*(97). Between 2001-2006, HSBC Bank U.S.A raised concerns on several occasions about the use of cover payments, as these payments prevented officers from checking whether they complied with the Office of Foreign Assets Control's requirements. These concerns were ignored.

As a result of this scandal, it is clear that HSBC were reckless and dishonest. HSBC were required to improve its anti-money laundering procedure; change its management structure and claw-back deferred bonuses to its senior officers in the anti-money laundering department. One area which still needs to be addressed is the whistleblowing procedure. The 2012 interim annual report does not have any whistleblowing mechanism and this is a gap to effective corporate governance. The case study on HSBC reveals failures in operational and reputational risks rather than capital and credit risks which the other banks faced. There was inadequate staff to deal with suspicious alerts; anti-money laundering controls were weak and important evidence regarding terrorist financing was ignored. HSBC have admitted failures and implemented changes to improve its anti-money laundering and terrorist financing systems. It is important for HSBC to strongly adhere to the changes and newly implemented policies. In 2003, HSBC announced new reforms to its anti-money laundering system when faced with an enforcement action by the Federal Reserve Bank of New York. Three years later, the bank's anti-money laundering programme deteriorated. Similar mistakes cannot take place again.

Conclusion

Good corporate governance practice plays a crucial role in guiding a company through challenging situations. This case study provides an opportunity to examine the weaknesses and failures of corporate governance of five UK banks at a micro level. The author has two hypotheses at the beginning of the study. First, banks moved from a customer driven culture to sales driven one. Secondly, the banking culture during between 2004-2009 is one of greed, recklessness and dishonesty. With the caveat that one should not make generalisations, there is evidence from the case study that both hypotheses are correct to a certain extent. Northern Rock adopted a risky and highly leveraged business model. It was heavily reliant one the wholesale market. When the sub-prime mortgage crisis hit the UK, Northern Rock suffered from a liquidity problem. The non-executive directors also failed to do their jobs properly. The Royal Bank of Scotland had weak capital ratios during 2007-2009. The takeover of ABN Amro was an expensive error. The bullying nature of board discussions prevented the opportunity for constructive and transparent dialogues. Whilst the FSA did not find that RBS amount a breach regarding management controls, they raised several corporate governance concerns. The LIBOR scandal hit RBS and the bank was fined £87.5 million in February 2013 for breaching section 206 of the Financial Services and Markets Act 2000 in the LIBOR scandal. RBS committed a number of breaches. Individual traders colluded with other firms and panels in manipulating the Japanese and Swiss franc LIBOR submissions between 2006-2010. At company level, RBS did not have adequate internal controls and processes to monitor risks associated with derivatives trading. Further, RBS attested in 2011 that they had adequate systems in place when they did not. Stephen Hester, the current CEO of RBS, admitted that there is a cultural problem in banking. Therefore, there is room for improvement at RBS.

The study into Lloyds Banking Group focused mainly on the governance issues at HBOS. HBOS pursued a traditional yet aggressive growth policy, where sales of products prevailed. The quality of assets was poor and solvency was the fundamental problem at HBOS. Risk management was poor and when the ex-Head of Group Regulatory Risk raised the alarm several times about the speed and nature of growth, his concerns were cast aside. The FSA's report into the failure of HBOS is clear that the bank was greedy, reckless and committed serious misconduct. There is evidence that greed, recklessness and dishonesty prevailed at Barclays. Several Barclays senior executives' remuneration packages were criticised publicly. There is evidence of a culture of fear within the bank and the LIBOR scandal revealed the dishonest and reckless nature of several bankers at the bank. Barclays were fined for their involvement in the LIBOR scandal in June 2012. The fine amounted to £57.5 million. Barclays started submitting false LIBOR and EURIBOR rates at the request of derivatives traders and other banks back in 2005. Several staff in New York, London and Tokyo were involved with manipulating LIBOR at Barclays. Barclays also tried to influence the EURIBOR rates of other banks and reduced its LIBOR rate during the financial crisis in an attempt to improve the negative image portrayed by the media. HSBC's corporate governance failures are different to the previous four banks in that HSBC failed in its operational systems. The report by the U.S. Permanent Subcommittee on Investigations exposed poor risks control and management. HSBC Group turned a blind eye to repeated concerns about malpractice regarding covered payments. The anti-money laundering department was seriously understaffed.

There is thus evidence overall, that both of the author's hypotheses are correct. To move forward, it is submitted that four steps are to be taken. First, there needs to be a shift back to customer focused banking, where customers are treated fairly and with respect. The study has revealed that aggressive, risky business models were used by some UK banks such as Northern Rock and RBS, where the focus was on selling products. Northern Rock suffered a liquidity problem since it relied heavily on short- and medium-term wholesale funding. It did not have adequate insurance or contingency facility to deal with the liquidity risk. RBS rapidly grew its loan exposure to the syndicated market. The acquisition of ABN Amro was a costly mistake for RBS. Secondly, the banking culture has to change so that a responsible and more stakeholder-centred approach is adopted. Profits and risk-taking are inherent to a bank but proper, effective checks and risk controls are required to assess risks. Banks have a social element in that individuals and business rely on them for financial reasons. Therefore, claw-back provisions in employment contracts are necessary when bankers make mistakes. HSBC and RBS have enforced claw-back provisions in the last three years. Thirdly, there needs to be open, honest and effective communication between lower, middle and senior management within banks. When alerts and alarms are raised, it is important that the concerns are investigated and not swept aside. Finally, sound whistleblowing procedures and policies need to be implemented, adhered to and practised to combat malpractice. When commenting on the FSA's internal audit report on the FSA's role in the LIBOR scandal, Lord Turner said that *'better whistleblowing procedures, greater accountability of top management and more intense requirements for self-reporting of suspicious activity may turn out to be more effective tools'*(98). Whistleblowing in the financial sector thus merits greater study.

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