


Global Analysts Settlement and **Systemic Operational Risks**

Institute of Operational Risk

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Agenda

1) The Global Analysts Settlement

- The Dot Com Bubble
- Research Analysts
- The Dot Com Bust

2) Systemic Operational Risk Events (SOREs)

3) **Why** do Systemic Operational Risk Events occur?

The Global Analysts Settlement*

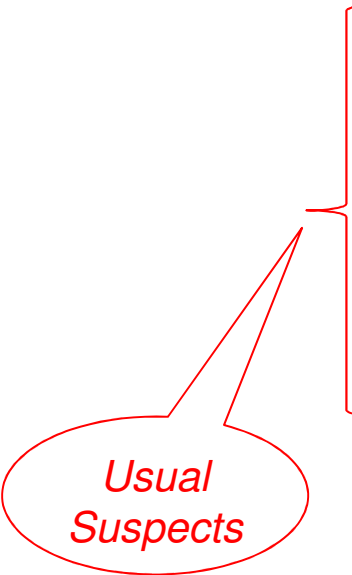
*McConnell P. J. (2018) 'Operational Risk – A forgotten case study'
Journal of Operational Risk, *September (?)*

The Global Analysts Settlement (GAS)

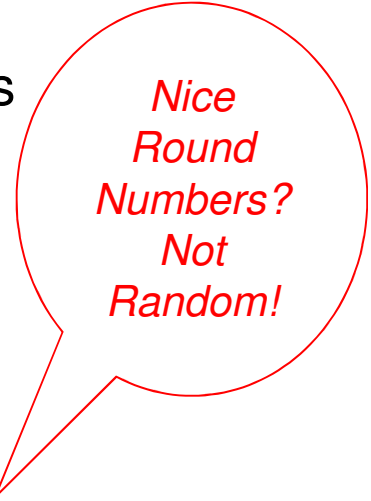
- In December 2002, a number of US financial regulators and agencies, led by the Securities and Exchange Commission (SEC), imposed **the largest fines up to that time** against **ten** investment banks and broker/dealers for **publishing misleading information to investors**.
- The fines and subsequent changes to industry structures were named the **Global Analysts Settlement (GAS)** and the regulators' remedies were aimed at ensuring that **Chinese Walls within investment banks were strictly enforced**
- Such wide-ranging fines and regulatory actions were unheard of until that time

The GAS Fines

- In April 2003, the fines and actions were finally agreed by the banks



Bank	Amount (\$ millions)
Citigroup/ Salomon Smith Barney (SSB)	400
Credit Suisse/First Boston ((CSFB)	200
Deutsche Bank	87.5
Goldman Sachs	110
JPMorgan	80
Merrill Lynch (now Bank of America)	200
Morgan Stanley	125
UBS/Warburg	80
Bear Stearns (now JPMorgan)	80
Lehman Brothers (bankrupt)	80
Other broker dealers, specifically Piper Jaffray and Thomas Weisel Partners	45
Total	1,487.5



- These fines were broken up as follows
 - Penalties: totalling \$525 million;
 - Disgorgement: totalling \$427.5 million, for illicit profits;
 - Investor research: totalling \$450 million set aside to develop research capabilities independent of trading firms; and
 - Investor education: totalling \$85 million to develop programs for investor education.

Structural Reforms to the Industry

- In addition to the fines and disbursements, regulators required that firms undertake a number of “structural reforms” to reform “industry practice” to protect investors,
 - 1) Research analysts were required to be “insulated from investment banking pressure”, i.e. **Chinese Walls were to be properly enforced**;
 - 2) The firms were obligated to “furnish independent research”, i.e. to **resolve conflicts of interest**; and
 - 3) Research analysts’ historical ratings and price target forecasts were to be publicly available, i.e. **disclosure**.
- New York Attorney General, Eliot Spitzer, said
"This agreement will ***permanently change the way Wall Street operates***. ... Our objective throughout the investigation and negotiations has been to protect the small investor and ***restore integrity to the marketplace***. We are confident that the rules embodied in this agreement will do so".
- Have we heard this elsewhere?

The Dot-Com Bubble

The Dot-Com Bubble

- From the mid 1990s through to 2001, the prices of stocks in technology companies on the New York exchanges soared in, what became known as, the 'Dot-Com' bubble (also known as the 'Internet' or 'Tech' bubble).
- In the last two years of the 20th Century, the Internet sector earned over 1,000 percent returns on its public equity and constituted some 20 percent of all publicly traded volume.
- During the Dot-Com bubble, start-up companies were coming to market with little more than a good idea on how to use the newly emerging Internet.
- The process of bringing a start-up to market is called an Initial Public Offering or IPO. An IPO would be brought to market and underwritten by an Investment Bank, such as Salomon Smith Barney (SSB), or sometimes more than one IB.
- A successful IPO is/was a very profitable transaction, provided the shares sold well when first issued! The key to success is/was to talk up the start-up IPO.

The Dot-Com Bubble

- However, in 2001, the bubble burst and many over-valued companies, and some investors, were wiped out.
- And some investors cried foul! Then regulators got involved.

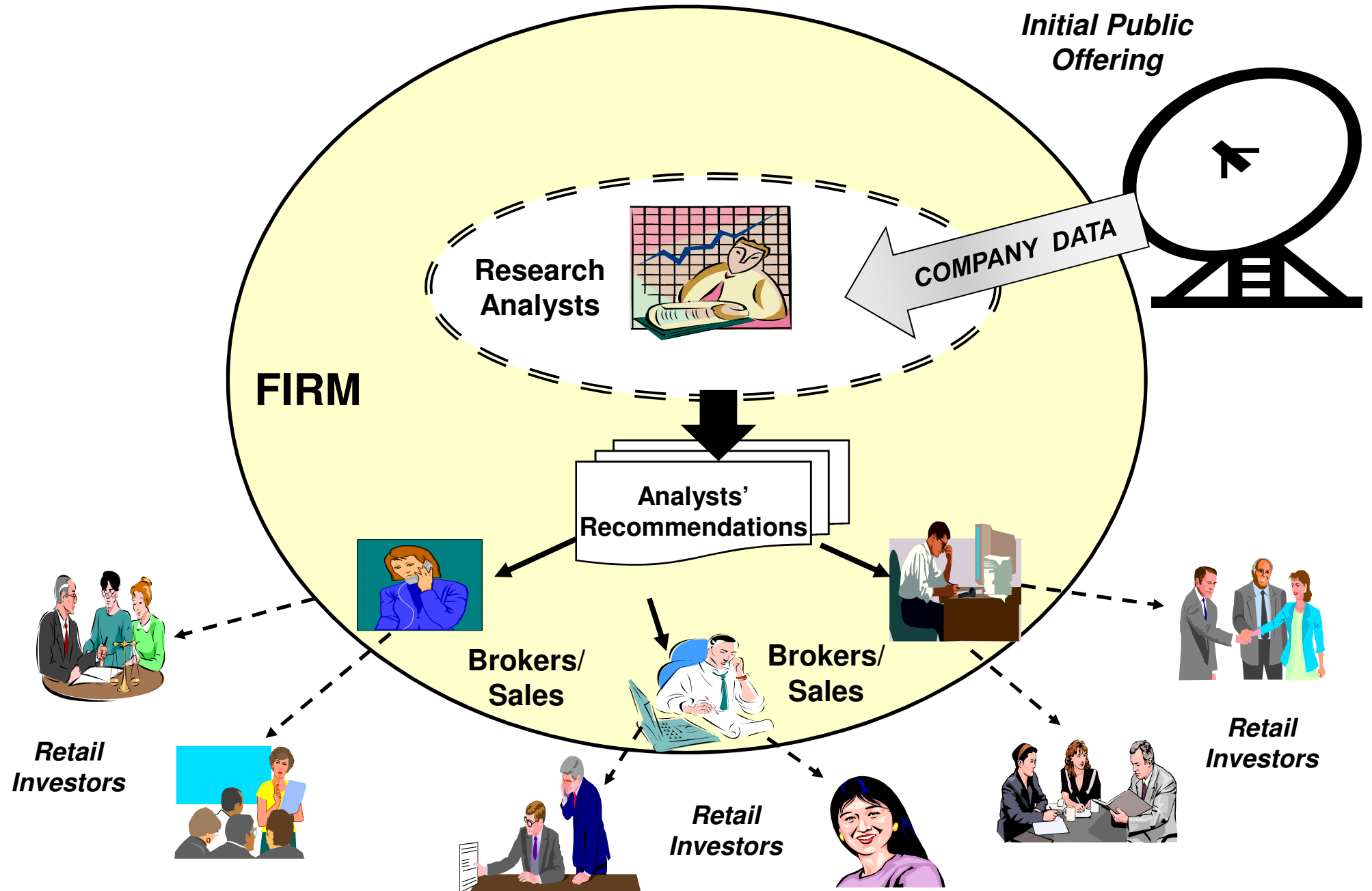


From <http://www.thebubblebubble.com/dot-com-bubble/>

Research Analysts

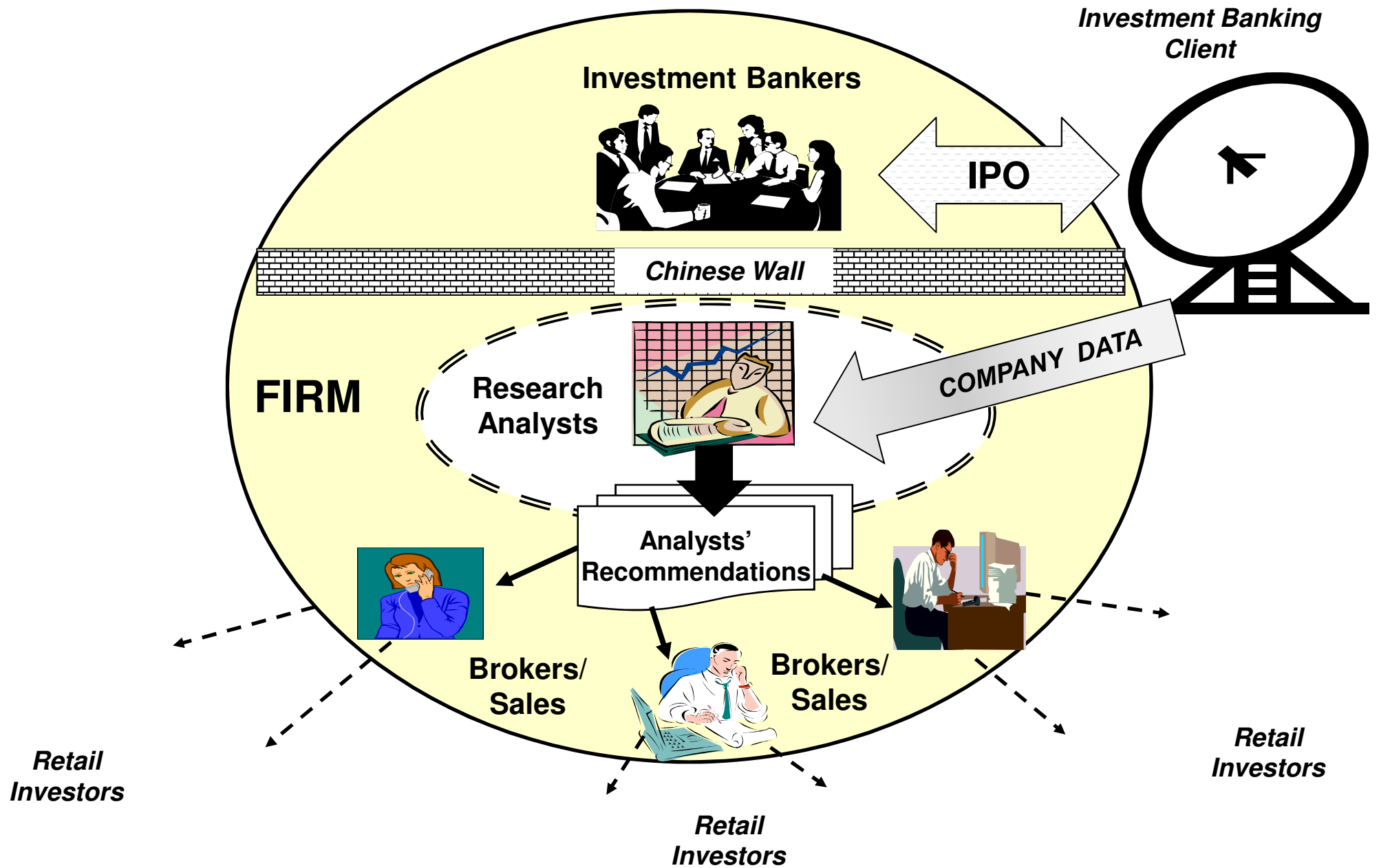
What does a Research Analyst do?

- In a brokerage department of an Investment Bank, a research analyst will ***provide recommendations*** to buy/sell particular stocks to the firm's brokers and sales people, who will then pass this information onto their brokerage clients and suggest that they buy/sell the recommended stocks.
- If an analyst's recommendations prove to be consistently good, brokers will enhance the firm's reputation for good advice and generate good fee income for the firm (from buying/selling stocks).
- Note the issuance of recommendations is subject to regulatory and exchange rules.
- Analysts will typically specialize ('follow') a particular industry sector, such as telecommunications or software, and will make recommendations based on gathering and analyzing public information from companies in their sector.
- In the Dot-Com boom, analysts who predicted (guessed? correctly) the performance of technology stocks (especially new IPOs) became super stars, were very well-paid and were poached by competitors.



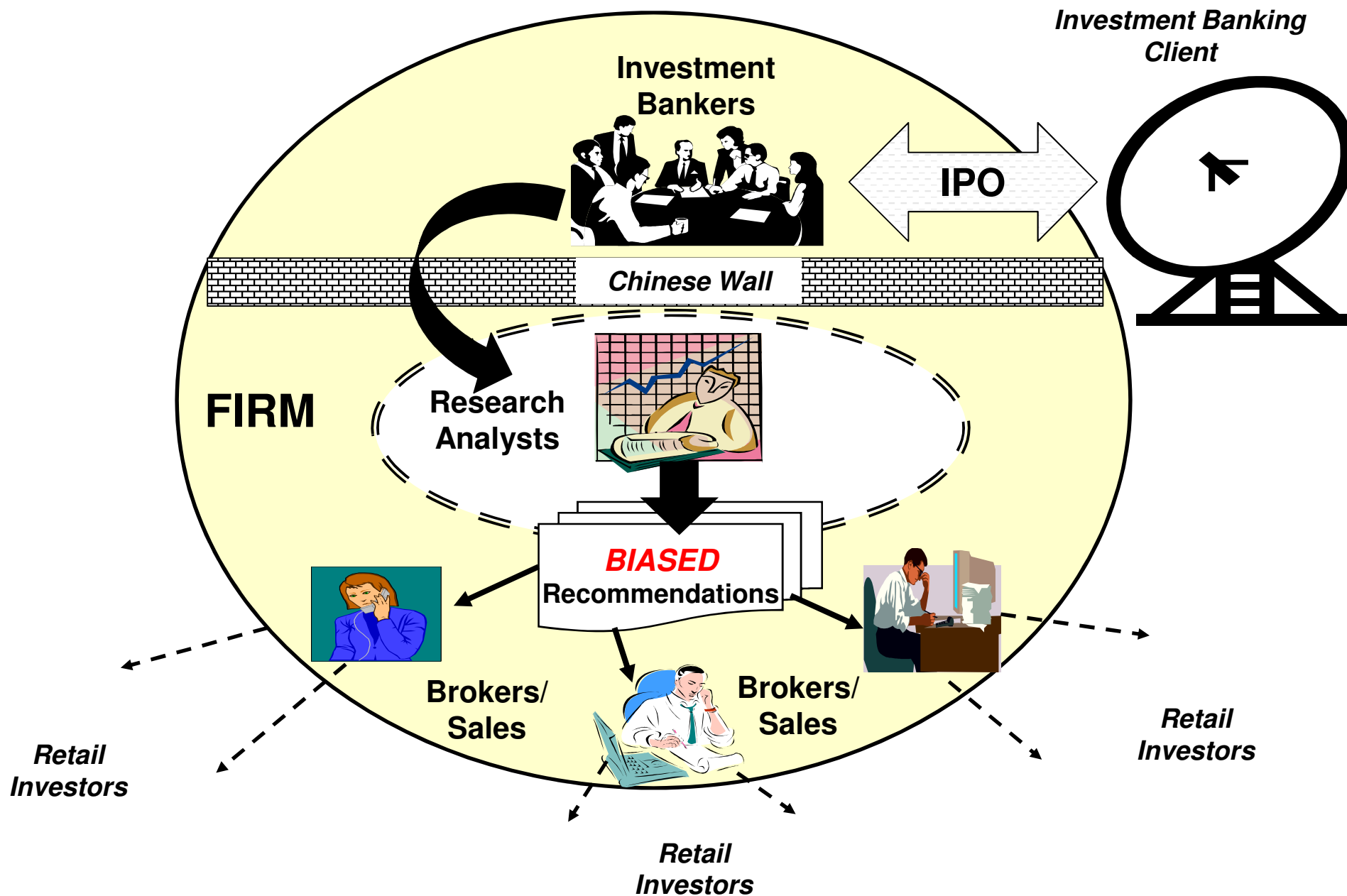
Conflicts of Interest

- Investment banks not only have client facing operations, such as brokerage, but also Corporate Finance/Investment Banking units that advise companies on (among other things) the issuance of new stock and for non-listed firms how to undertake an IPO.
- So, at any time, a firm may dealing with an individual company on two levels:
 - 1) Advice on issuing and underwriting an IPO; and
 - 2) Making recommendations as to whether to buy the new stock or not!
- There is obviously a conflict of interest here, especially if an analyst decides to recommend against buying stock in an IPO that is underwritten by the Investment Banking division
- There must be Chinese Wall between the two departments



Easier said than Done!

- What if a firm underwriting an IPO also has one of the most respected research analysts in the industry?
- Surely, they are going to ask his/her opinion on the viability of a new company before pitching for an IPO mandate?
- In fact, bringing along a highly respected industry expert to meet the owners of a potential IPO, might also help gain the IPO mandate and/or protect the firm from underwriting a ‘turkey’.
- And, of course, having given an off–the-record opinion, an analyst will be on the hook, especially where the Investment Banking division can help to determine the analyst’s remuneration.
- Once on that slope, it gets very slippery, very quickly



The Dot-Com boom, stopped booming!

- As the number of IPOs increased during the Dot-Com boom, the pressures increased on Investment Banking units to create new highly profitable IPOs.
- And as volumes and profits grew, the pressures increased on Research Analysts to at least not make a sell recommendation on a firm's own IPOs and preferably to issue a buy.
- But that was not a problem during the boom, because every new stock was going up in price anyway!
- And everyone was happy - until the music stopped!
- And the music stopped when investors found out that many of the recommended IPOs had little/no hope of making profits.

After the Boom, the Bust

After the Dot-Com boom

- When stock prices began to fall, it became obvious that many of the new technology stocks were over-valued ***and always had been!***
- Suspicion began to fall on the investment banks that had promoted the failing IPOs and then onto the research analysts who had provided glowing recommendations to buy stocks, only to change their mind a few months later as prices fell.
- Some investors who had lost money then became very loud
- It became political, when the Attorney General of New York, Eliot Spitzer, became involved and started an investigation into the Dot-Com 'crash'.
- Then the regulators, especially the SEC, began to do their jobs.

It's the emails stupid!

- In what later became standard practice, investigators gained access to internal emails at banks and it was a treasure trove.
- Investigators discovered that:
 - **Chinese walls were almost non-existent** with investment bankers and research analysts actively working together on IPO deals;
 - Research analysts **were being pressured** to give good recommendations;
 - And research analysts were also **openly disparaging** IPOs to which they had given buy recommendations;
 - Investment bankers were **openly hostile to research analysts** when their IPOs were later downgraded;
 - **Brokers were openly complaining** about buy recommendations that were obviously too optimistic, and were losing clients as a result;
 - In order to gain new IPO mandates, investment bankers were **giving inside information** on new IPOs to potential clients (called 'spinning')
- The email evidence was pretty damning

It's the test cases stupid!

- In what also became standard practice, investigators decided to concentrate on a few egregious cases (rather than all examples)
- Investigators chose two test cases, with an extensive email trail:
 - 1) **Henry Blodget**: a research analyst at Merrill Lynch who had made a biased recommendation on a company that about to be purchased by one of the bank's clients; and
 - 2) **Jack Grubman**: a 'star' research analyst at Salomon Smith Barney (SSB) and expert in the Telecommunications sector, who had apparently adjusted recommendations to suit the firm's Investment banking business.
- Initially, the banks rejected the regulators' claims, but faced with the email evidence, rolled over and agreed to settle – the other banks followed pretty quickly.
- This approach of threatening to shame the banks became standard practice for later scandals.

Why has this particular case been forgotten?

- On many levels, the Global Analyst Settlement(GAS) is a template for later scandals, such as LIBOR manipulation.
- This is a clear case of Conduct Risk, so why has it been forgotten?
- First, it happened in 2002 and 2003 which is when the final form of Basel II was being debated, before being published in 2004.
- The GAS did not fit the thinking on Operational Risk at the time, which was heavily focused on process failures and rogue traders and was driven by Op Risk Capital issues which were focused on ***idiosyncratic*** (firm specific) risks.
- It is only later, after the GFC, that People and Conduct Risk began to be considered as the main source of Operational Risk.

Systemic Operational Risk Events

A Systemic Operational Risk Event

- The Global Analyst Settlement (GAS) is an example of a Systemic Operational Risk Event (SORE)
- GAS was an Operational Risk Event
 - An example of People Risk , subset Conduct Risk
 - Basel II Loss Event Type Level 1 category ‘Clients, Products & Business Practices’ (CPBP)
- The misconduct was
 - **Systemic** – with multiple banks, being fined by multiple regulators *for the same misconduct*, at roughly the same time;
 - **Systematic** - the misconduct had become ‘business as usual’ within each bank and across the system;
 - **Significant** – largest fines until that date;
 - **Negotiated** - Fines (i.e. losses) were negotiated (i.e. not arbitrary);
 - **Clustered** – Losses were clustered in time and correlated (same regulators).

SOREs Database

- Author collected and documented Operational Risk Events with value >US \$5.0 million, from 2000 to 2014
 - ORX Data - 78% of loss data value results from 1% of events > €5.0 million
 - These are the **extreme** events that dominate ORC calculation
- The research concentrated on risk events that caused operational losses either as regulatory fines or as settlements that involved restitution for customers.
- Sources -not news but original sources:
 - Regulators' web-sites
 - Bank Annual Reports
 - Bank Press Releases
- In all, 188 losses collected totalling some \$233 billion*

* converted to US\$ at average annual rates

Summary of SOREs Database (*as at mid-2015*)

Highlights	Total (\$ Billion)	% of Total
Total All Large Losses (> \$5.0 million)	233.7	
Total Systemic Risk Losses	212.1	91%
<i>Related to Mortgage Misselling and Abuse</i>	128.0	55%
<i>Related to Misselling, e.g. PPI, IRHP</i>	41.4	18%
<i>Related to Manipulation, e.g. LIBOR, FX</i>	21.5	9%
<i>Related to Other Misconduct, e.g. TAX, AML</i>	21.5	9%
Total Losses Specific to a Firm	21.6	9%
<i>Total Specific Losses to Non SIFI</i>	5.9	3%
Systemic Losses		
<i>Since 2011</i>	214.1	92%
<i>In SIFI bands 2-4</i>	184.0	87%
<i>For G15 Banks</i>	196.8	93%
<i>US and UK banks</i>	192.6	91%
Types of Loss		
<i>Fines, Settlements and Restitution</i>	194.5	83%
<i>Provisions for Redress</i>	39.4	17%

Over 90% of total due to Systemic Events

Less than 10% due to Idiosyncratic Events

Almost 90% by Too Big To Fail Banks

Basel II does not recognise Provisions

- The largest Operational Risk Events are ***not idiosyncratic!***
- But Operational Risk Capital (ORC) is ***calculated on that assumption***

Summary of Database by SRC and Bank

Idiosyncratic
= 9.2%

PPI still
growing

RMB still
growing

SR Code	Systemic Risks	(\$ Billion)	% Total
ARS	Auction Rate Securities	0.5	0.2%
BRM	Benchmark Rate Manipulation	10.3	4.4%
EMM	Electricity Market Manipulation	0.9	0.4%
FSP	Firm Specific	21.6	9.2%
FXM	FX Benchmark Manipulation	10.3	4.4%
GAS	Global Analyst Research Settlement	1.5	0.6%
IRH	Interest Rate Hedging Products	5.2	2.2%
MFA	Mortgage Foreclosure Abuse	18.2	7.8%
PPI	PPI Redress and Provisions	34.0	14.6%
RMB	RMBS Misselling, Repurchase	109.8	47.0%
SML	Sanctions, Money Laundering	16.0	6.8%
TAX	Tax Avoidance/Evasion	5.5	2.3%
Total		233.7	100.0%

Bank	%Total
Bank of America	34.3%
Barclays	5.2%
BNP Paribas	3.8%
BNY Mellon	0.4%
Citigroup	7.1%
Commerzbank	0.6%
Credit Suisse	1.8%
Deutsche Bank	3.8%
Goldman Sachs	1.8%
HSBC	3.0%
ING Bank	0.3%
JPMorgan Chase	13.0%
Lloyds	7.4%
Mitsubishi UFJ	0.2%
Morgan Stanley	0.6%
Other	4.7%
Rabobank	0.5%
Royal Bank of Scotland	3.9%
Santander	0.9%
Societe Generale	0.3%
Standard Chartered	0.4%
State Street	0.3%
UBS	2.1%
Wells Fargo	3.3%

Other
Banks

- Losses are dominated by SOREs
- Losses are dominated by TBTF banks
- Losses are dominated by RMBS (i.e. GFC) fines, > 47%
- But others are significant, especially PPI, Market Manipulation and Money Laundering

Some Recent Operational Risk Events (*not comprehensive*)

- Systemic Operational Risk Events

- 2018 Barclays \$2 billion for mortgage related misconduct
- 2018 UBS, Deutsche Bank, HSBC - \$47 million for benchmark manipulation
- 2018 PPI now estimated at some £35 billion (≈\$50) billion (+25% since 2015)
- 2018 BNP Paribas - \$90 million for Forex manipulation (DOJ)
- *2017 BNP Paribas - \$246 million for Forex manipulation (Fed)*
- *2017 BNP Paribas - \$300 million for Forex manipulation (DFS)*
- 2017 Deutsche Bank - \$7.2 billion for misselling RMBS
- 2017 Credit Suisse - \$135 million for Forex manipulation
- 2016 Credit Suisse - \$5.3 billion for misselling RMBS
- And So on and So On



***Latest
RBS \$4.9 Bln
RMBS***

- Firm Specific (i.e. Idiosyncratic) events

- 2016 - Wells Fargo - \$185 million customer misselling (*also Strategic risk?*)
- 2017 - Commonwealth Bank Australia - \$289 million provisions AML breaches
- 2017 - Several large frauds , BNDES (Brazil), Shoko Chukin (Japan), China etc.

*But **WHY** do Systemic Operational Risk Events occur?*

Multiple Cultures

- Edgar Schein (guru of Organizational Culture) identified four different categories of 'culture'.

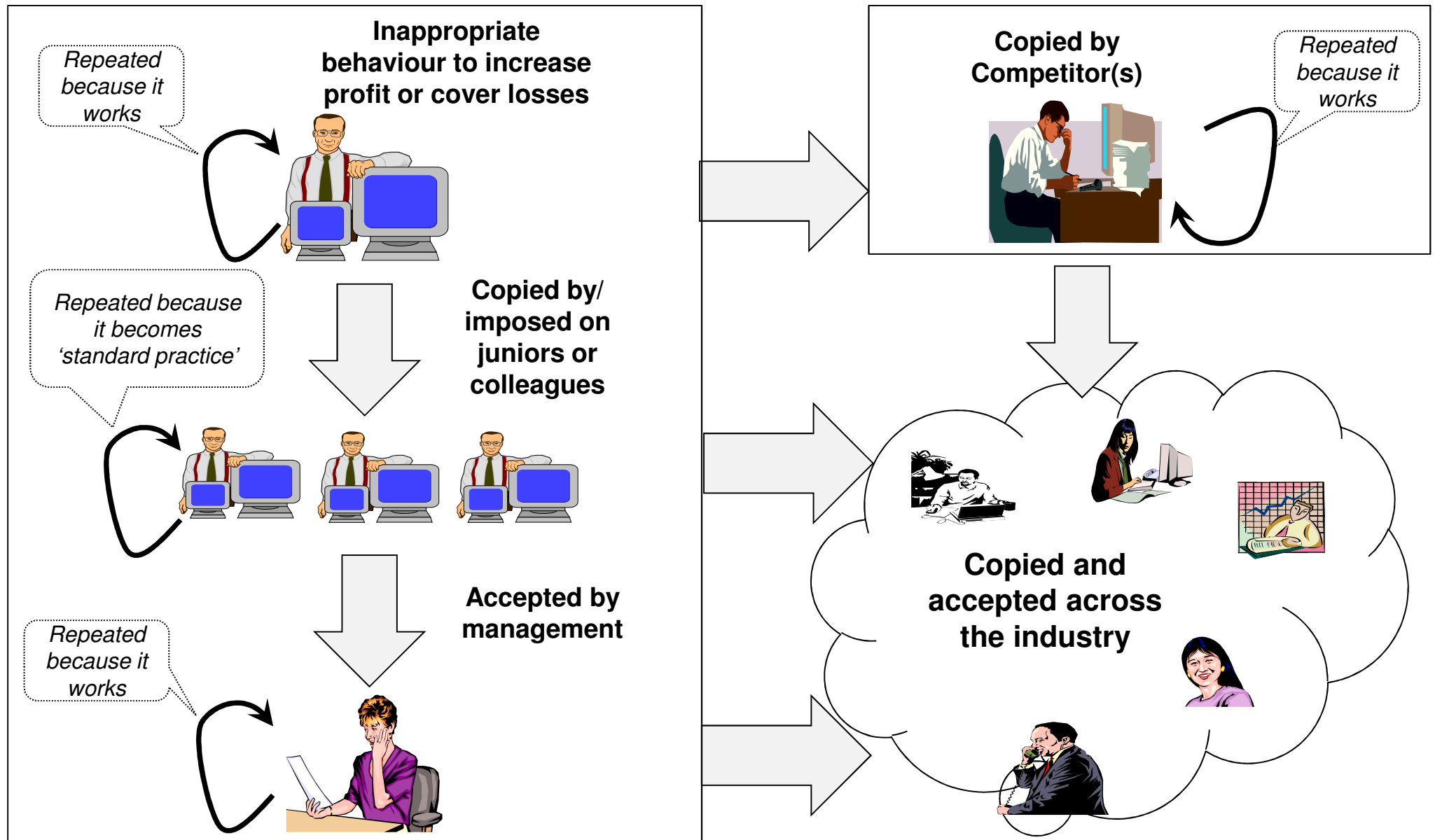
Culture	Category (Schein)	Examples in Banking
1) Macro -cultures	Nations, ethnic and religious groups, <i>occupations that exist globally</i>	Accountants, Investment Bankers
2) Organisational cultures	Private (Corporate), public, non-profit, government organisations	Banks, Insurers
3) Sub -cultures	Occupational groups within organisations	Risk Managers, Operations
4) Micro -cultures	Microsystems within or outside organisations	Specialised functions, such as internal auditors or IT staff

- For example, Accountants form a distinct macro-culture, with Shared Assumptions (e.g. accounting standard bodies); Shared Operational Models (e.g. IFRS9) ; and Shared Education (such as CPA etc.).
- There are often multiple sub-cultures ***within*** a firm and firms exist ***within*** multiple macro-cultures, such as Retail Banking, Investment Banking, Insurance etc.

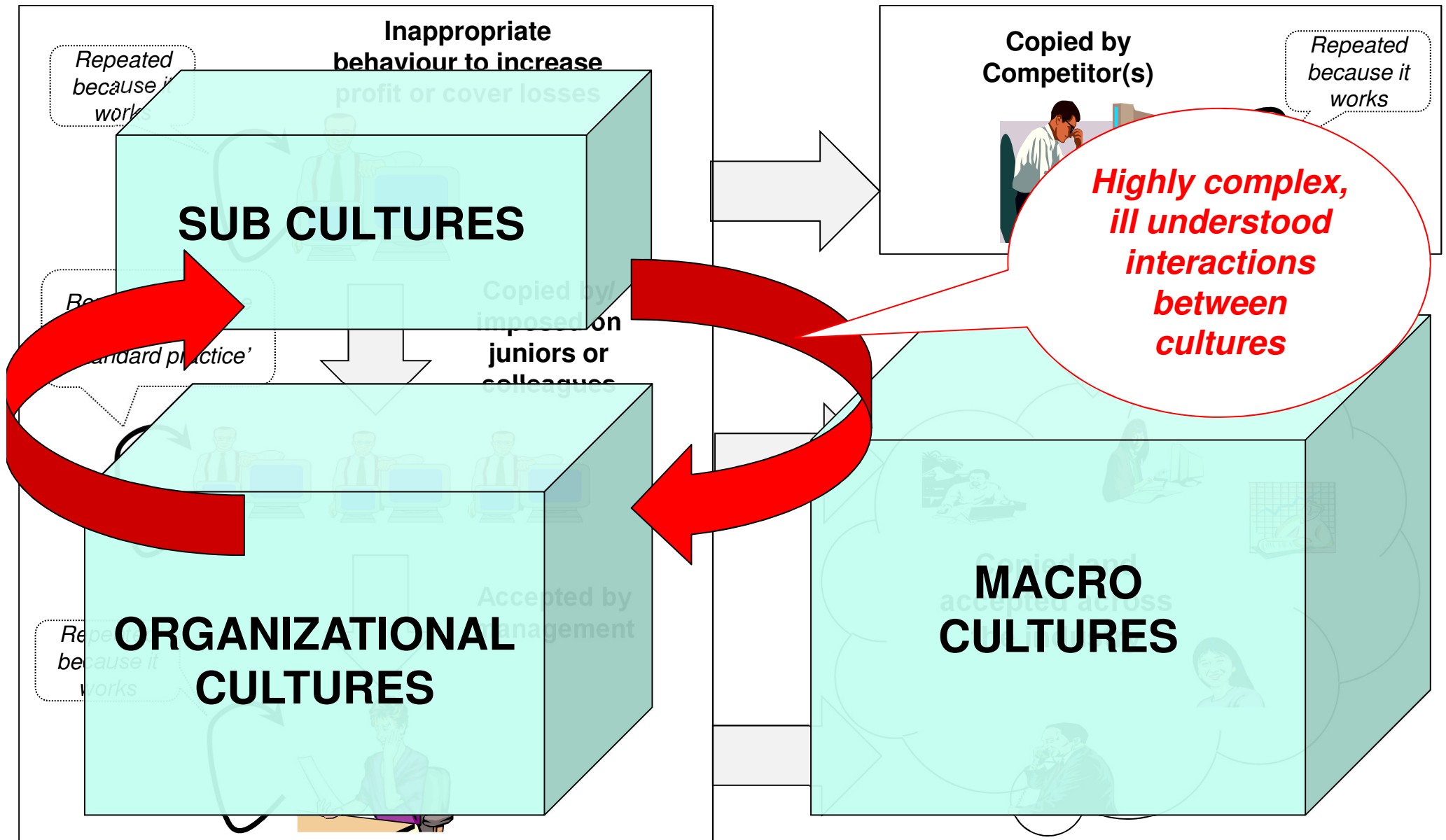
Banking is a Small World

- Banking is a “**small world**”
 - Dominated by a relatively small number of large firms (100s);
 - That are head-quartered in a small number of large financials centres (10s);
 - Deal in similar product families (100s);
 - Governed by similar rules (e.g. Basel, IFRS9);
 - Run by a relatively small number of highly trained specialist staff;
 - Staff move between firms regularly and carry and percolate knowledge;
 - This is even more true when looking at specific areas, such as Interest Rate and FX Trading, Mergers and Acquisitions, Brokerage, even Retail Banking
- In other words, there are identifiable ‘macro cultures’ with
 - 1) **Shared Assumptions**: about how markets operate and regulation works;
 - 2) **Shared Operational Models**: such as SWIFT and settlement systems;
 - 3) **Shared Education**: standard accreditation, courses and conferences.
- And importantly, there is **NO** protection for Intellectual Property (IP)

Evolution of Bad (and Good) practices



Interactions between Organizational and Macro Cultures



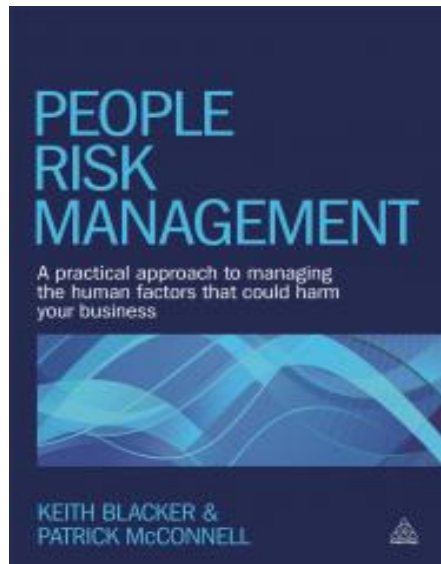
Question:

Why can we not find a good solution to the Operational Risk Capital problem?

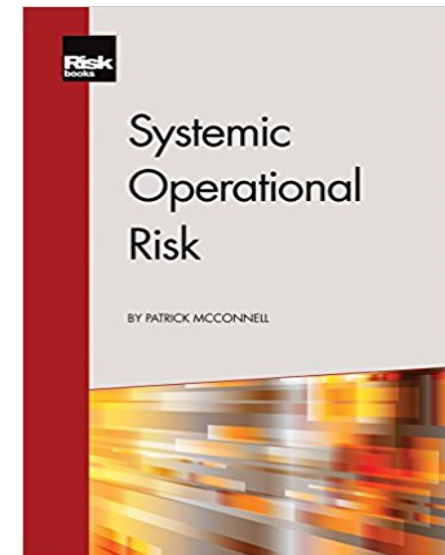
Answer:

Because we are looking in the wrong place!

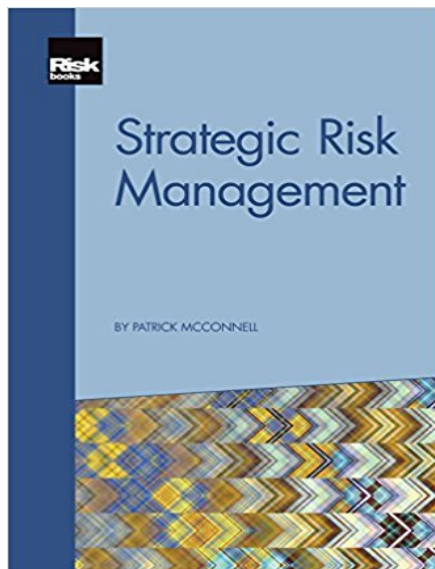
PEOPLE/CONDUCT RISK



OPERATIONAL RISK



STRATEGIC RISK



TECHNOLOGY RISK



Thank you

Questions?

Case References

The following papers and books describe some important cases in detail

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