September 2016

Short-Termism and its Potent Influence on Corporate Culture at Financial Firms
The Octopus in the Room

By Gene Phillips, Joseph Heller, CFA and Chris Coleman-Fenn, Ph.D.
Contents

Short-Termism, a Growing Problem .................................................................3
Background........................................................................................................3
Setting the Scene ...............................................................................................5
The Current Environment for Financial Firms ..................................................6
   Exposure to the Downside ..............................................................................7
   Short-Term Investors Steer Short-Term Focus ............................................7
   Costs Up. Revenues Down ...........................................................................8
   Cutting Costs ................................................................................................10
Valuation Issues ................................................................................................11
   Hard-to-Value Assets and Securities ..........................................................12
   Hurry Up the Upside; Slow Down the Writedown .....................................13
   Thought-Piece: The “London Whale” (April 2012) ....................................15
Structuring, Trading & Execution Issues ..........................................................16
   Thought-Piece: When Does Salesmanship Cross the Line? .....................17
Challenges Ahead and Next Steps ....................................................................19
Framing a Solution ............................................................................................20
An Approach to an Approach ..........................................................................22
Addendum 1 .....................................................................................................24
Addendum 2 .....................................................................................................25
Key .....................................................................................................................26
Endnotes ............................................................................................................27
Short-Termism, a Growing Problem

We want what we want, and we want it now!

*Short-termism* generally refers to our biological responsiveness to our more primitive impulses: fear and greed. We prioritize near-term profits over longer-term gains.

On a company-level, short-termism can culminate in firms discounting or ignoring remote outcomes: they might underinvest in valuable research or projects whose payoffs would only be realized in a distant future.

Short-termism is not a problem unique to companies or the financial markets. Governments and politicians alike must constantly weigh short-term interests – like being elected or re-elected – when making strategic and policy decisions. Start-ups, generally, need to be mindful of their immediate cashflow concerns and their imminent deliverables. Public companies have to concern themselves with their current stock prices, while their CEOs contend with retaining their positions.

But while short-termism is not particular to financial firms, the issues they face are idiosyncratic, with their personnel being particularly susceptible to their immediate impulses.

For one, their historical remuneration structures entrenched a mindset among their personnel, that focuses on forthcoming bonuses, which (problematically) are often closely linked to each individual’s or the firm’s short-term performance. Crucially, financial firms employ risk-taking personnel who, as a function of their jobs, are often exposed to profit-and-loss ("P&L") streaks beyond their control, which can trigger primitive impulses. For example, in the face of a losing streak, traders can quickly flip from being conservative and risk-averse to being risk-seeking – akin to the “double-down” mentality.

As we seek to show, some of the complications facing financial firms — including newly introduced, well-intended regulatory measures — demand immediate attention. Unfortunately, it is often when dealing with numerous and large-scale immediate demands that companies implement ill-considered, quick-fix solutions.

Moreover, in a world in which stakeholders increasingly bring with them short-term viewpoints, and demand swift measures from management to address them, the problem of short-termism may be a growing disturbance.

Background

Financial institutions are exposed in a number of ways to their personnel running amok or “going rogue.” When such an incident occurs, the question is often asked whether the employee has in fact gone rogue, or whether her conduct is consistent with the principles engendered within the firm: the corporate culture.

Since the financial crisis, much has been made of the culture at 21st century corporations, particularly financial institutions. Several critics blame the value system on Wall Street – the perceived devil-may-care attitude among Wall Street traders that came from an asymmetric remuneration structure – as a core component of a banking environment that knew few limits. The banks were prepared to engineer, take, or pass along any number of risks, culminating in the worst financial panic since the Great Depression.

“[The foregoing] analysis suggests that a person who has not made peace with his losses is likely to accept gambles that would be unacceptable to him otherwise. The well known observation ... that the tendency to bet on long shots increases in the course of the betting day provides some support for the hypothesis that a failure to adapt to losses or to attain an expected gain induces risk seeking.”

— “Prospect Theory: An Analysis of Decision under Risk” by Kahneman and Tversky (1979)
Senior executives and board members have since been grappling with how to instill value systems in their organizations that better reflect their own, or broader community, expectations. They are not merely paying lip service to the importance of corporate culture: it truly does permeate throughout a company, influencing (sometimes explicitly) the motivations and priorities of all employees, from front-office producers to back-office control staff.

In a May 2016 speech, U.S. Securities and Exchange Commission (“SEC”) Chief of Staff Andrew J. Donohue expounded on the significance of corporate culture:

“A culture of always doing the right thing, not tolerating bad practices or bad actors is essential. The culture should encourage people to ask questions and to discuss openly what is the proper response to a particular issue and how conflicts should be resolved. It should hold the higher up members of the firm to at least the same standard of conduct as those below them …

Another sign of the culture of a firm is whether there is a correlation between ethical behavior and the firm’s reward structure, such as salaries, bonuses and promotions. Are people who are less complaint nevertheless rewarded? It is also telling in a firm when questions are being asked, conflicts being resolved or decisions being made, is the discussion solely about whether we can do this or is it also about whether we should do this? Is it the right decision or course of action for the firm and its clients? I always appreciated how extremely difficult it would be to have responsibility for the corporate compliance function within a firm that did not have a good culture.”

This drive is not confined to the United States. Australian Securities & Investments Commission (“ASIC”) chairman Greg Medcraft noted, “What the board says, does and most importantly expects, is absolutely critical in setting the tone for the organisation.” Clearly, the SEC and other regulators globally are looking for corporate boards and senior management to set the standard for their firms’ principles and to shoulder more responsibility. This drive, importantly, can reduce the potential for moral hazard, limiting the ability for upper management to be shielded from the consequences of poor decision making.

Other regulators, too, have sought to describe what they see as problematic conduct at financial institutions. However, the guidance is in its early stages and presented at a higher level. Few specifics have been detailed as to the mechanisms or initiatives to be implemented in achieving a desirable outcome.

“Senior management must establish the right culture to convert good intentions into fair outcomes for consumers. We do not consider it reasonable for firms to compromise on fair treatment of customers in the name of financial success.”
— Financial Conduct Authority

Much of the initial focus has come with an emphasis on corporate governance, including the typical arguments for creating a diverse board; ensuring the board is neither too large nor too small; and setting a tone from the top, ensuring that middle-management steers the junior staff in concert with the hoped-for tone. These are good ideas. But they are often run-of-the-mill solutions, offered in a way that makes them generally applicable to many firms, but not necessarily geared towards financial institutions.

While it is difficult to define an ideal, and it may be seen as beyond the purview of regulatory bodies, articulating the issues can help financial firms address regulatory and stakeholder concerns.

In the financial markets, short-termism can manifest itself sharply, with personnel promoting their own or their firm’s immediate interests to the detriment of their firm’s longer-term goals.

Financial firms seeking to build or maintain a cultural environment conducive to their long-term prosperity are presented with a difficult balancing act: they need to clearly delineate between acceptable and frowned-upon risk-taking. To do so, management needs to understand the incentive structures at play throughout their firms, and the distinguishing factors that can motivate an employee to put himself first (before the company), the company first (before its clients), or the clients first.

With this cultural objective in mind, we seek to describe the complications from a practitioner’s perspective and, recognizing that there is no panacea, we hope to add to this debate by putting forward a framework that firms could adopt in engineering their own specific solutions.
Setting the Scene

In early September 2016 the Consumer Financial Protection Bureau (“CFPB”) fined Wells Fargo Bank $100 mm for its “widespread illegal practice” of secretly opening unauthorized deposit and credit card accounts. According to Wells Fargo’s own analysis, its employees opened two million deposit and credit card accounts that may not have been authorized by consumers.3

- Deposit Accounts: Wells’ employees transferred funds from consumers’ accounts to temporarily fund the new, unauthorized accounts.

- Credit and Debit Cards: Wells’ employees applied for roughly 565,000 credit card accounts that may not have been authorized; they also issued debit cards without consumers’ knowledge or consent, and even created PINs without telling consumers.

Customers were harmed in the process, incurring fees or interest charges on cards unknown to them or unrequested, and overdraft fees on accounts from which monies were temporarily taken to fund the new accounts.

But relative to our context here, what is most interesting is the cultural tone set at the bank, and how the bank’s standards and principles may have influenced its employees. Wells Fargo has claimed to have terminated 5,300 employees involved; but was this a concerted effort among thousands of employees, going rogue?

A lawsuit4 filed in Los Angeles against Wells in 2015 (on behalf of the People of the State of California) presents a picture of a cultural issue at Wells – not an issue with the employees, but with an intense, outcomes-based incentive structure that created anxieties among the personnel who found it difficult to satisfy the steep, often unrealistic demands. The goal set was to increase the number of bank accounts or products held by each Wells customer, to eight: the so-called “Gr-eight” initiative. The lawsuit claims that employee sales quota systems were strictly enforced – those failing to hit their numbers were “approached by management, and often reprimanded and/or told to ‘do whatever it takes’ to meet their individual sales quotas.” Employees were monitored on a daily basis: district managers would discuss daily sales for each branch and employee “four times a day, at 11 am, 1 pm, 3 pm and 5 pm.”

Anecdotes have since surfaced from disenchanted (former) employees, who describe a pressure-filled environment in which they felt they needed to open whatever accounts they could to meet their targets before going home that day. According to the former employees, management was well aware of the challenges presented and of the unauthorized accounts being created. They claim that managers did not care about the “quality” of the new accounts or their potential for revenue production: the employees were credited with simply opening the new accounts, allowing them to earn additional compensation and to meet the bank’s sales goals.

The Los Angeles filing claims that the “quotas imposed by Wells Fargo are often not attainable because there simply are not enough customers who enter a branch on a daily basis for employees to meet their quotas through traditional means.” With employees being “hound[ed], berate[d], demean[ed] and threaten[ed]” to meet these unreachable quotas, the lawsuit argues, they were “naturally and predictably forced to resort to alternative means.”
The Current Environment for Financial Firms

While short-termism has been a known issue for some time, several factors in today’s environment have the potential to make matters worse. This section explores some of these factors, in anticipation of a framework we propose to buffer against them. But we first explore a set of more general concerns that firms tackle on a daily basis, many of which stem from, or were accentuated by, the recent financial crisis:

- Financial crisis litigation matters (e.g., subprime mortgages, RMBS, CDOs) and subsequent benchmark manipulation cases (e.g., LIBOR, ISDAFIX, FX) have left financial institutions facing seemingly endless litigation, with post-crisis fines and settlements, for the large US and European banks, already exceeding $180 bn.\(^5\)

- Financial firms have been subjected to increased risk management, regulatory and compliance requirements, creating both immediate and ongoing costs (for new personnel, systems, related paperwork, and expenses associated with the heightened levels of oversight by regulatory/supervisory entities).

- Financial institutions are facing something of an identity crisis: many policy-makers are calling for banking to become more “boring” and utility-like, in order to shield the economy and taxpayer from externalities resulting from banks taking outsized risks. Firms have had to adopt higher capital requirements and management has had to balance the need for safety against the entrepreneurial spirit that drives many risk-taking employees on Wall Street.

- Financial firms have also suffered reputational damage, making their ongoing efforts to attract prized personnel ever more challenging. To make matters worse, a chief competitor for talented hires — the technology sector — has been booming, while offering an attractive “coolness” factor. Would-be customers are also ever more open to pursuing alternatives to the traditional banking options, prompting a whole portion of the start-up technology industry dedicated to changing the financial landscape: so-called “FinTech” companies. FinTech is driving automation and rendering some human roles redundant. For example, so-called robo-advisors like Wealthfront and Betterment are beginning to take the place of traditional financial advisors. Compared to the FinTech revolution, and to a degree as a result of it, careers in finance are becoming less appealing. (Although, it must be said, some of these FinTech firms are starting to encounter their own difficulties, with the reality not quite living up to the hype.)

Several of these issues may be particularly worrying: a despondency towards working in the financial sector was already evident in the creation of several poorly-constructed financial arrangements leading into the recent financial crisis, as demonstrated by the “IBG-YBG” mentality referenced in the following quote.

A focus on short-term profits also permeated the industry. One of the witnesses here today will describe how when he once questioned a banker about the terms of a deal, the banker replied, “IBG-YBG.” When asked what that meant, the banker explained, “I’ll be gone you’ll be gone” – in other words, why give me a hard time when we are both making a lot of money and will be long gone before the house of cards comes crashing down.

Excerpt from Opening Statement of US Senator Carl Levin
Senate Permanent Subcommittee on Investigations (April 2010)
The subcommittee also made available a quote drawn from a December 2006 internal email between employees at rating agency S&P: “Rating agencies continue to create an even bigger monster – the CDO market. Let's hope we are all wealthy and retired by the time this house of cards falters.”

**Exposure to the Downside**

Much of the short-term thinking at financial firms is driven, unsurprisingly, by remuneration incentives. An employee’s level of enthusiasm about the work involved, and his sense of duty or loyalty to his firm, can be heavily influenced by the firm’s payment structure and his level of involvement in, and exposure to, its prosperity.

For example, the pre-crisis movement away from the partnership model garnered much attention by those trying to explain the origins of the crisis. Years before, the large investment banks had been run as private partnerships. With the firms’ officers also being partners in the organization, they enjoyed the upside of their firms’ profits but also were exposed to the downside. These institutions steadily went public or merged with other public companies. By the time Goldman Sachs went public in 1999, the largest U.S. investment banks were all publicly held companies.

With employees and directors having less personal exposure to downside risks, the argument went, they became less conservative with their firm’s capital, and paid less attention to whether their and others’ actions were in accordance with the firms’ long-term interests.

Whether the act of investment banks going public, in and of itself, creates more positives than negatives is debatable. But it creates an environment in which certain downside risks, previously held by partners, are shared or passed on to investors: with that comes the increased potential for “short-term” thinking, a risk that has to be managed.

**Short-Term Investors Steer Short-Term Focus**

Short-term thinking patterns among firms’ managers are also often the result of the (increasingly) short-term interests of investors.

Equity investors have been shortening their time horizons – they trade in and out of positions with greater regularity. As seen in the following chart from LPL Financial, capturing data at 10-year intervals from 1940 to 2010, the average holding period for stocks has declined from several years to less than one year. Ned Davis Research puts the average holding period in 2015 at just 8.3 months.™

---

© Copyright 2016 PF2 Securities Evaluations, Inc. All Rights Reserved.
While some of the recent decline may be attributable to changes in market structure, the trend towards condensed holding period times is unmistakable.

Stakeholders’ transitory lens can drive management to similarly skew its emphasis to the near-term: shareholders are less patient about stock performance and quicker to sell out of positions they believe will underperform in the short-term. This, in turn, can push management to focus on immediate stakeholder concerns. Management often needs to be responsive to (even capricious) investor sentiment, as much of management’s variable compensation is paid in the form of company stock or stock options. Another explanation is that management needs to be alert to the possibility of being fired by the board – itself attuned to stakeholder interest. Directors themselves might fear the wrath of activist investors who could push to replace them if the activists do not view the board to be adequately pursuing shareholder interests.

Executives feel pressure to meet investors’ profit expectations every quarter, lest an earnings miss triggers an impulsive selloff. With this short-term mindset in place, managers are less willing to put short-term profits at risk in pursuing longer-term growth strategies.

An argument can be made that, by rewarding short-term production above all else, firms have been run for the benefit of their employees and short-term investors, to the detriment of the firms’ long-term interests. The concern is that the short-term investor interests prompt the making of short-sighted decisions.

Renowned investor and entrepreneur Peter Thiel (co-founder of Pay-Pal), in making the unconventional argument that monopolies are not necessarily bad, explained that: “monopolies can keep innovating because [monopoly] profits enable them to make the long-term plans and finance the ambitious research projects that firms locked in competition can't dream of.”

The short-term pressure applied by stakeholders is not unique to financial firms. But it helps to explain their decision-making processes in an environment that, as we shall see, makes revenue growth all the more challenging.

**Costs Up. Revenues Down.**

While many or most businesses are regulated – for workplace safety standards, privacy issues, environmental protection, hiring and employment practices – the regulation of financial institutions (even pre-crisis) takes on an extra dimension, with central banks, federal agencies and local regulators analyzing bank operations. Former chairman and CEO of BB&T, John Allison, would explain entertainingly that: “In theory, CEOs report to boards, who then report to shareholders. While that's true of most businesses, in the financial services industry, we only quasi-report to boards, quasi-report to shareholders, and definitely report to regulators.”

Post-crisis, financial firms have been tied up with a bevy of expensive, though arguably justifiable, regulatory reforms stemming from the Dodd-Frank Act (enacted in July 2010). Annual regulatory costs have rocketed: the American Action Forum estimates the cumulative additional costs imposed by Dodd-Frank (already) amount to $36 bn.

---

*a* One possible explanation for this change in holding periods is that shares are increasingly held by professional investment managers, instead of “buy-and-hold” retail investors. Investment managers tend to be compensated for annual performance, rather than longer-term performance, limiting their willingness to ride out short-term pains. They are often looking for quick scores, and less frequently investing to reap the benefits of long-term earnings growth. Moreover, investment managers need to be mindful of investors pulling their money from the fund, further skewing their incentives to the shorter-term.
With some of the legal regulations still being finalized and implemented by various regulatory entities, the page count is up to 22,000, and growing. According to a Davis Polk report, as of July 2016 almost 30% of Dodd-Frank’s rules had yet to be finalized.\(^{11}\)

Stress tests pose another source of anxiety: large US banks (and foreign banks with large US subsidiaries) undergo stress tests annually, in accordance with which the Federal Reserve determines whether the firms would be able to maintain adequate capital levels in various macroeconomic scenarios. Chartis Research estimates that in 2016 global banks will spend $4 bn on information technology for stress tests.\(^{12}\)

A second part of the examination, termed the Comprehensive Capital Analysis and Review ("CCAR"), subjects banks’ proposed capital plans for Fed approval. Effectively, the large banks must get the Fed’s seal of approval before initiating dividend issuance and share buyback plans.

Regulators have also imposed higher capital requirements, particularly for larger institutions, with the Federal Reserve demanding yet further capital surcharges for firms considered among the most systemically important. Risk-based measures (e.g., Tier 1 common ratio) and straight leverage measures (e.g., Tier 1 leverage ratio) have been raised as a buffer against firms going insolvent. While higher capital standards ideally leave banks safer, they also render them less profitable, as measured by return on equity.

On top of the more strenuous capital requirements, large banks must comply with Basel III’s Liquidity Coverage Ratio ("LCR") requirement, which mandates that firms hold a certain amount of high-quality liquid assets ("HQLA") which can be easily converted into cash during times of stress — the goal being to withstand a “30 calendar day liquidity stress scenario.”\(^{13}\) The LCR aims to make firms more resilient, but it lowers profitability: holding higher levels of (typically lower-yielding) HQLA lowers banks’ return on assets ("ROA"). The processes have not yet drawn to a close, with expectations that changes from the forthcoming Fundamental Review of the Trading Book will increase market risk capital requirements by a further 40%.\(^{14}\)

While compliance and regulatory capital costs are rising, top-line \textbf{revenues} are facing strong headwinds too.

As interest rates decline, the interest income earned on loans and securities declines more than banks’ borrowing costs. Global banks have been battling against compressed net interest margins ("NIMs"), the measure of the difference between a bank’s interest income (e.g. from loans and securities) and interest expense (e.g. from deposits and long-term debt), as a percentage of average earning assets.\(^{15}\) This is partly because some of a bank’s deposits are non-interest bearing (e.g., checking accounts) and therefore are not impacted by changes in interest rates.\(^{16}\)

With rates remaining at or near historical lows, banks continue to struggle to generate strong returns on their interest-earning assets.
In addition to pressure on the NIMs, dealers are seeing reduced margins in an area where money-making opportunities used to be prominent: over-the-counter (“OTC”) transactions, paramount among fixed income and derivatives trading.

Similar to equity trading two decades earlier, fixed-income and derivatives trading is evolving from a process that is dominated by large broker-dealers to one where all participants can transact with each other on electronic exchange-like platforms. In the swaps world, for example, these platforms are called Swap Execution Facilities (“SEFs”). This trading evolution is multi-pronged, driven mostly by technological advancement and regulatory diktat.

First, technological innovation is bringing speed and transparency to financial markets where, in the past, customers relied solely on bilateral communications with dealers for price discovery and trade execution.

Second, new regulations in Dodd-Frank require dealers to participate on SEFs, with some qualifications and exceptions. The combination of technology and regulation has brought with it greater transparency (both pre-trade and post-trade), thereby democratizing precious flow information that used to be controlled exclusively by dealers. The process is still evolving, with dealers trying to maintain the status quo, to varying degrees of success. Electronic market makers such as KCG, Virtu Financial and Citadel Securities, as well as electronic trading platforms like Liquidnet and Bloomberg LP, threaten large broker-dealers’ entrenched advantages, although some broker-dealers have ownership stakes in electronic trading platforms (such as Tradeweb).

Furthermore, higher capital requirements, imposed post-crisis, make it more costly for banks to make markets and to put the firm’s capital at risk in facilitating bond trading. Bond dealers are pulling back from capital-intensive trading. According to one analysis, in aggregate, dealers are committing 20-25% less balance sheet capacity towards trading in fixed-income, currencies and commodities (“FICC”) compared to 2010, with another 10% reduction expected over the next four years.17

In the past, a dealer could take down a large block of bonds from a customer looking to sell, and it could offer immediate execution to the customer. The dealer would then hold the bonds in inventory while it sought out willing buyers, over the coming days or even weeks. To be compensated for the immediate execution and for absorbing the risk entailed, dealers could expect to purchase large blocks at a discount, earning profits as they exit the position over time.

With the help of new electronic platforms, buy-side players are now able to fill this void, providing liquidity to other market participants and bypassing the dealer intermediary. A portfolio manager explained this shift to Bloomberg Markets, relating a trade in which he estimates he saved $50,000 by avoiding dealer interaction:

“Now it’s more of a level playing field, as dealers have been pulling their balance sheet and simply crossing trades,” he said. “We have stepped in to provide liquidity.”18

Cutting Costs.

With revenue growth being strained by macroeconomic factors, such as the low interest rate environment and slow nominal GDP growth in the developed world, cutting costs has been seen as the key way for banks to increase profits.19

But with compliance costs on the rise, any attempt to reduce overall costs requires sharper cuts in other areas. A recent study20 claimed that over 10,000 front-office jobs had been cut by the top 10 banks since 2011, with roles being made redundant across various business lines: even during the last year, the headcount in FICC is reported to be down 8%.

Bank of America has been particularly aggressive about cutting costs and trimming its payroll: the bank’s headcount has dropped by about 70,000 since 2010;21 it is planning a further $5 bn in annual cost cuts within two years.22
Goldman Sachs CEO Lloyd Blankfein told an audience in February 2016 that: “We take a particular and energetic look at continued cost cuts when revenues are stalled.”

One cost-cutting method being employed, including by Citigroup, is the minimization of office space, by foregoing assigned seating for certain roles, such as human resources or information technology. Akin to unassigned parking, employees would need to find an available seat each day.

Another technique has been the drive to “employ” short-term contractors and consultants at the expense of permanent employees. With contractors and consultants often being able to do the work at a fraction of the cost (taking optionality into account) firms are financially motivated to hire them. They are also easier to fire, from a legal perspective. Consulting and contract work are on the rise, particularly in areas such as back-office, compliance, accounting, IT and controls. A recent headline is indicative of the trend: “Demand for financial services contract workers soars in the City.” Worldwide, banks spent roughly $29 bn on consultants in 2015.

With the dual pressures leaving firms’ profit margins being squeezed on both ends, the concern is that employees and firms might be increasingly prone to making quick-fix adjustments to fill holes left in their trading P&L, or earnings, more generally. We now discuss two key areas that are vulnerable to employee misconduct: valuation issues and trading/execution shortcomings.

**Valuation Issues**

One of the areas vulnerable to employee misconduct is in the valuation of company assets. The concerns can generally be divided into three sub-categories, although in many ways the categories overlap:

- mispricing of securities held;
- optimistic projections made on speculative financial assets; and
- delays in the writing down of less-promising assets.

In an October 2008 letter, the Financial Services Authority (“FSA”) in the United Kingdom set out its firmly-held view that it was a “bad or poor practice” to allow a situation in which employees “have an ability to influence unduly the valuation of their own positions and hence the determination of performance measures,” or the “[ability] to front load profit from transactions.”

The FSA wanted to encourage a more prominent adoption of independent checks and balances – and to limit the potential for overly aggressive accounting assumptions. Valuation, after all, is a core concern for financial institutions, and valuation deficiencies lie at the center of numerous institutional failures.

---

**Pricing Example: Visium Asset Management**

In June 2016, the SEC accused two of Visium’s portfolio managers (“PMs”) of having “routinely manipulated the valuation procedures of the advisory firm that advised [Visium’s] Credit Fund … by using sham broker quotes to mismark — i.e., misprice or overvalue — securities held by the Credit Fund.”

The SEC alleged that the PMs obtained these quotes at inflated prices from brokers friendly to them, in a process called a quote “U-turn.” The PMs allegedly communicated their desired prices to the friendly brokers, only for the brokers to then relay the quotes back to the PMs as if they had been independently constructed.

The mismarking reportedly resulted in Visium overstating the Credit Fund’s NAV by $11 mm to $26 mm (between 2% and 7% a month). In a related investigation, the SEC brought insider trading charges against another portfolio manager, who committed suicide soon thereafter.

Accordingly, financial institutions spend large sums of money each year valuing their own assets, including on the checks and balances the FSA referred to in 2008.

In several ways firms and their managers can influence, or be influenced by, their approach to valuing their assets.

At some public companies, compensation packages are tied to performance metrics such as profit or revenue growth or simply a change in stock price — and management can become fixated with the boosting of earnings and the associated bump in share price. These measures can also affect a company’s cost of capital. A senior executive, whose remuneration is tied to a
specific metric (like earnings-per-share) may have an incentive to game that specific measure, for example by encouraging a debt-financed share buyback (which may have a minimal impact on the overall economics of the firm, but would increase its earnings-per-share).

Next, valuations can affect a firm’s capital costs. For example, on the back of inflated asset valuations, earnings are boosted, which drives a perception of strength. Stronger companies may be able to borrow at lower interest rates in the bond market – and lower interest costs will in turn enhance future profitability. Perception can therefore begin to drive reality. Similarly, stronger reported earnings (premised on inflated valuations) may make it less costly for a company to issue shares. If a firm can issue shares at higher prices, it can raise the same amount of money via fewer shares, resulting in less dilution, meaning future earnings per share results would be higher, all else equal.

In sum, asset valuations are all-important. They can affect: performance (and bonuses); the ability to raise or access funds; and the funding costs themselves. Inflated valuations can also reduce the amount of regulatory or risk capital that needs to be reserved against the positions held.

To stave off concerns that financial incentives could prompt an improper approach to asset valuation, some firms have taken measures to ensure that their procedures are sound and their valuations are objective. Recently, Bridgewater Associates, the largest hedge fund manager in the world, decided to implement valuation procedures requiring two outside asset evaluators (BNY Mellon and Northern Trust) to reconcile valuations with one another.

**Hard-to-Value Assets and Securities**

The less predictable its payoff stream, the more challenging it can be to value an asset or the receivables coming from a project or operation.

Most types of companies have to estimate revenues under hypothetical or projected scenarios. Some firms, like oil and gas exploration companies, may have to evaluate assets or projects that have yet to be approved or begin production. Others, like construction firms or even law firms, might need to evaluate projects or cases that have already begun – often called “Works in Process” or “Works in Progress” – but which have variable outcomes associated with them, based on externalities like dates of completion or even success rates (both of which would need to be estimated).

Financial institutions are certainly not immune to having to make projections. Critics argue that bank financial statements are overly vague, claiming that a bank's income is just a guess at the midpoint of a wide probability distribution of how much money it might actually have made, filtered through one of several semi-arbitrary accounting conventions.28

There are some interesting structures, however, that enable firms to assume upfront that everything will work smoothly – and they are able to allocate profits upfront before seeing how the risks play themselves out.

---

28 Projections on Uncertain Assets: Platinum Partners

In August 2016, it was reported that Platinum Partners, the celebrated hedge fund, was being investigated for potentially inflating their accounting for certain “hard-to-value” assets, on the back of which they have been reporting robust returns (17% annually, on average).

Among the assets are Californian oil fields, said to failed to achieve any meaningful production, yet reportedly priced as being Platinum’s most valuable assets.

Sterling Valuation Group, the valuation provider, stated that its valuation of $176 mm was based on information provided to it by Platinum (and a 2013 report by DeGolyer and MacNaughton), and that “if Platinum Partners and others provided incomplete or inaccurate information, then we would no longer stand by the report.” One source cited estimated that the oil fields would have fetched only about $10 mm at the relevant time.

Hurry Up the Upside; Slow Down the Writedown

Gain-on-sale accounting provides a way for companies to book upfront their expected future income, based on inputs that allow management considerable leeway. Management may be tempted to use aggressive assumptions that inflate the present value of the expected future income stream, to the detriment of earnings quality and reliability.

In some ways this is similar to overvaluing an asset, leaving all downside risk for the future. It can be troublesome: it takes yet-to-be-earned future “profits” off the table and often pays them out in salaries or bonuses today, leaving few reserves for those unfortunate occasions in which the downside risks come to pass.

According to Moody’s:

“Under gain on sale accounting, income statements reflect the present-value of lifetime earnings from assets in a single quarter, predicated on numerous assumptions and calculations. Reported earnings may give a false sense of the long term ability of the company to repay debt.”  

Securitization – Separating Risk and Return

Securitization is a process by which securities are created from pooling underlying assets. The payables on the assets, like credit card and mortgage loans or bonds, become receivables to the securitization trust. For example, one thousand $500,000 home loans might support a $500 mm RMBS.

Securitization has been used as a tool for diversifying risk, but it is also a tool for transferring the risk from one risk taker to the next – often from a risk-taker who had intimate knowledge of the risk taken to a risk-taker who assumes the risk associated according to certain representations and warranties made to it along the way. The risk is passed from the original risk-taker, who is compensated up-front, to the less-informed party who sits at an information disadvantage.

Securitization works well when it allows well-informed investors to share the risks on an investment. But its effectiveness can be compromised, and the potential for “adverse selection” exists when the original risk-takers (the originators) allow lending standards to drop – or fail to adequately describe them – to the detriment of the ultimate bearers of risk (the investors in the trusts).

The troublesome application of the securitization process lay at the heart of the financial crisis: The originate-to-distribute model enabled lenders to be paid upfront, irrespective of whether the borrowers would ultimately make their payments. With the avenue of securitization available to originators, lending became a short-term game – no longer a play for patient capital. They simply had to lend, and not necessarily to lend well to strong credits. Originators knew they could pass on poorly underwritten loans, en masse. Their incentive was therefore only to lend, en masse.

This disconnect in incentives precipitated an inevitable decline in lending standards. Through securitization, it was the RMBS trust investors who bore the risk, and they ultimately suffered when the poorly-underwritten loans went sour.

In the early 2000’s, following widespread criticism concerning the pitfalls of gain-on-sale accounting, many underwriters chose to structure their securitizations in such a way as to avoid using gain-on-sale accounting. However, even after the Financial Accounting Standards Board (“FASB”) updated its securitization accounting rules with FAS 140, securitizations accounted for as a sale were required to still use gain-on-sale accounting.30

Mortgage servicing rights (“MSRs”) are one such example of products created pursuant to gain-on-sale accounting. Upon originating mortgage loans, the originator generally holds the rights to service the loans originated. These MSRs are valuable, and are often traded by originators.

Due to their heavy reliance on assumptions, MSR valuations are a potential source of accounting trouble. For example, in 2003 National Australia Bank was sued over a $2.2 bn MSR writedown at HomeSide Lending, a U.S. subsidiary, with the argument being that HomeSide Lending had previously inflated the value of its MSRs (thanks to overly optimistic assumptions).31

© Copyright 2016 PF2 Securities Evaluations, Inc. All Rights Reserved.

→ Back to Contents
Techniques similar to gain-on-sale were among those responsible for enabling the magnitude of leverage at banks leading into the crisis, and exacerbating the potency of the downturn once it began.b

When putting together and selling so-called “ABS CDOs,” securitizations backed (ultimately) by residential mortgages, the bank underwriters would often retain all, or a large portion, of the super senior AAA-rated tranche – each regularly $500 mm or more – only to then insure them (via credit default swaps) with highly-rated insurance companies.

The insurance premiums would cost less than the notes paid in interest, giving the banks a positive projected annual cashflow, as long as the insurance companies would be able to support any shortfalls. This trade, called a “negative basis trade,” was essentially considered a perfect hedge for accounting purposes: it was conceptually “risk-free,” meaning that it could reside entirely off balance sheet.

More importantly, to value the benefit of the trade, the banks could evaluate all future receivables from the carry trades and count them as profit at the onset, before seeing whether or not they worked out.

As it happened, when the downturn came many of the insurance companies quickly folded, meaning that these contracts would return to the banks’ balance sheets – which led, ultimately, to the need to bail out several of the banks.

UBS would later explain that:32

“Day1 P&L treatment of many of the transactions meant that employee remuneration (including bonuses) was not directly impacted by the longer term development of positions created.” … and

“Employee incentivisation arrangements did not differentiate between return generated by skill in creating additional returns versus returns made from exploiting UBS’s comparatively low cost of funding in what were essentially carry trades … the UBS funding framework amplified the incentives to pursue compensation through profitable carry trades.”

Some approaches to booking gains or estimating receivables may be more artful than others. But the evaluations need to be steadily modified to remain consistent with the then-current environment: otherwise when the correction occurs it can create numerous difficulties.

A company might also delay writedowns on assets in the hope that market conditions will improve and the asset in question will regain much of its value.

When the Financial Crisis Inquiry Commission (“FCIC”) reviewed documents relating to Goldman Sachs’ collateral calls of AIG, leading up to AIG’s 2008 failure, it uncovered a revealing conversation between two employees of AIG. At the time of an early but sizeable margin call, one AIG employee explained to the other that:

Gain-on-Sale: Green Tree Financial

In the 1990s, Green Tree Financial was the largest originator of loans for manufactured housing (i.e., trailer homes), financing 40% of that market at the company’s peak.

Green Tree utilized gain-on-sale accounting to record profits on loans that it originated and then securitized or sold, but retained some of the risks and economic interests in the loans.

Green Tree’s default assumptions proved overly optimistic, and eventually it and (later) Conseco, which acquired Green Tree in 1998, suffered heavy losses from writing down its inflated assets ($2.3 bn over 4 years).

In 2002, Conseco was forced to file for Chapter 11 bankruptcy protection, making it the third largest bankruptcy in U.S. history, at the time.

---

b In May 2008, less than four months prior to its bankruptcy filing, Lehman Brothers reported a debt-to-equity leverage ratio of more than 20. (SEC 10-Q filing of May 2008: $613 bn of debt divided by $26 bn of equity). This number would have been even higher had Lehman disclosed its application of the notorious “Repo 105” and “Repo 106” devices, according to its bankruptcy examiner, “to temporarily remove securities inventory from its balance sheet, usually for a period of seven to ten days, and to create a materially misleading picture of the firm’s financial condition in late 2007 and 2008.” Lehman would artfully increase its usage of Repo 105 “in the days prior to reporting periods to reduce its publicly reported net leverage and balance sheet.” (Report of Anton R. Valukas, Examiner, March 11, 2010; http://web.stanford.edu/~jbulow/Lehmandocs/VOLUME%203.pdf)
“We can’t mark any of our positions [at market price], and obviously that’s what saves us having this enormous mark to market. If we start buying the physical bonds back then any accountant is going to turn around and say, well, John, you know you traded at 90, you must be able to mark your bonds then.”

The implication is that if AIG avoided trading in similar bonds, it could carry on as if those bonds were not being valued by the market at lower prices. It could delay appropriately marking its own books.

One of the more fundamental financial statement identities is **Equity = Assets – Liabilities**.

If asset writedowns cause equity to fall enough, the bank may be forced to raise equity capital in order to meet its regulatory capital requirements. More nefariously, if the bank knows that it will need to raise equity, it could delay its writedowns until it has completed its secondary offering, especially if the writedowns are worse than the market fears (as implied by current share price).

### “Extend and Pretend” or “Delay and Pray”

Firms exposed to under-performing or non-performing assets might not want to take the write-down, or might not want to recognize and accept the loss just yet.

One option available is to re-write the contracts for delinquent loans — to extend them — in such a way that the debtors are no longer technically behind on payments. Sometimes this works, especially when debtors only need some leeway before coming current again.

But sometimes it does not, and a market slowdown can magnify or exacerbate the problem, with those who have extended their loans or delayed their writedowns being forced into a day of reckoning.

Warren Buffett is often quoted as having said: “you only find out who is swimming naked when the tide goes out.”

A variation of this phenomenon is seen when banks restructure non-performing loans to stave off defaults: often referred to as “extend and pretend.” Management might even believe that certain non-performing loans are ultimately destined to cost the bank in higher charge-offs (beyond what is written down upon restructuring the loan), but it can delay that inevitability by restructuring the loans.

Another incentive for delaying a writedown may be earnings smoothing. In general, less volatile earnings garner higher price-to-earnings multiples, and by extension higher share prices.

Thus, a firm might wait to make an announcement, until it has a highly profitable quarter or other positive news or optimistic guidance to share — to minimize the earnings impact of the writedown. If released among a set of more important developments, it would have a less dramatic effect on the share price and be less likely to stir questions from bank analysts and investors. Holding on to higher valuations can also help to reduce risk capital needed to be reserved in the interim: lower levels of (historical) volatility are interpreted to imply a lesser probability of large losses in the future, too.

### Thought-Piece: The “London Whale” (April 2012)

JPMorgan’s handling of the “London whale” saga presents an interesting case study worth exploring, with a dynamic interplay between a company’s public comments and the risks associated with an ongoing, large, and risky trading position.

In early April 2012, news articles circulated suggesting that JPMorgan’s Chief Investment Office ("CIO") held credit derivatives positions so large that they were moving the market and distorting credit derivatives indices. The

---

© Copyright 2016 PF2 Securities Evaluations, Inc. All Rights Reserved.

→ Back to Contents
articles also reported that some traders were referring to JPMorgan’s trader responsible for the positions as “the London whale.” Later, on JPMorgan’s April 13, 2012 earnings call, CEO Jamie Dimon downplayed the risk posed by the large positions, calling it “a complete tempest in a teapot.”

Losses on the positions quickly grew as JPMorgan worked to trade its way out of the positions. By the May 2012 call with analysts to address the concern, Dimon revealed that losses had reached $2 bn and that further losses were possible in the near-future, in the order of another potential $1 bn. The following day, JPMorgan’s shares fell over 9%. By the July quarterly earnings release, losses had reached $5.8 bn and JPMorgan announced that it needed to restate its 10-Q filing for the first quarter of 2012. On the earnings call before the market opened for trading, CFO Douglas Braunstein stated, “The restatement is really based upon recent facts that we’ve uncovered regarding the CIO traders’ intent as they were marking the book. And as a result, we questioned the integrity of those trader marks.” JPMorgan’s shares rose nearly 6% by the end of trading that day.

Whether or not JPMorgan’s management team actually believed the trades posed little material risk, it is worth considering the motivations at play here: what kind of impact could management’s comments have had on the performance of the positions themselves and the firm’s ability to extricate itself from them? Had Dimon made public statements emphasizing a larger range of potential losses, it could have become even more onerous for JPMorgan to unwind its problematic positions or caused other incidental damage to the company: market players may have then sensed JPMorgan’s desperation and may have made it more expensive and difficult for JPMorgan to exit its positions.

The approach is tricky: at worst, JPMorgan’s public statements warning of large potential losses could be self-fulfilling and risk exacerbating the losses themselves.

Visit Addendum 1 for further examples of Valuation Issues

**Structuring, Trading & Execution Issues**

“There is widespread concern that inappropriate remuneration schemes, particularly but not exclusively in the areas of investment banking and trading, may have contributed to the present market crisis” …. “It is possible that [the remuneration structures] frequently gave incentives to staff to pursue risky policies, undermining the impact of systems designed to control risk, to the detriment of shareholders and other stakeholders, including depositors, creditors and ultimately taxpayers.”

— FSA, Dear CEO letter, October 2008

In contrast to some banking practices in which banks work alongside their clients to engineer a mutually desirable outcome, the determination of fees and commissions is often a zero-sum game: each dollar earned by the firm is a dollar paid by the client.

With this in mind, it can be challenging for firms to prompt eager personnel to appropriately weigh their interest in generating short-term revenues (at the firm’s clients’ expense) against their firm’s interest in maintaining client relationships cultivated over many years.

But the frequency of costly regulatory and enforcement investigations into hidden fees or markups highlight this as a key concern for financial institutions. And it should be: even if the amounts are relatively small, undisclosed fees and commissions can sour even the strongest of client relationships. Hard-earned clients may be tempted to take their business elsewhere if they feel they have been taken advantage of.

* As it happened, external credit derivatives traders were reportedly well aware of the magnitude and nature of JPMorgan’s positions, and were likely positioning themselves to capitalize on the unwinding, regardless of Dimon’s public statements.
An employee’s drive to generate immediate revenues from clients can run counter to the firm’s interests in maintaining repeat business with those clients.

At worst, employees may employ a strategy of charging clients “as much as they can get away with.”

To combat the potential for this motivation, Goldman Sachs purportedly fostered an internal mantra encouraging their employees to be “long-term greedy.”

Some traders see themselves as intermediaries whose role involves completing a deal or trade on behalf of clients, while also maximizing their firm’s profits (or minimizing losses). Others may feel that they can use a certain amount of discretion in the degree to which they are forthcoming with their clients. Yet others view their sole purpose to be maximizing the firm’s profits (or minimizing losses), by any means necessary, as long as they are not lying to their clients – the reality being that their customers may be sophisticated institutional clients who potentially have just as much information and market knowledge as the traders themselves. 9

In short, employees often have divergent opinions (and a poor understanding) of the responsibilities associated with their roles. The challenge, then, is to understand the prevailing mindsets among employees across the firm and craft guiding principles specific to the duties assumed in each division.

Example: Citigroup M&A Emails

After locking up a sale in a prominent M&A deal in 2007, investment bankers at Citigroup exchanged emails. “I am amazed you got them to pay up for that old pup,” one banker wrote. “At long last you sold the pig,” wrote another.

Communications such as these may not be well received by a court upon discovery; but they also force us to consider the bankers’ perspectives in getting a deal done. Here Citi’s personnel may feel that they served their client (the seller) well, by getting the buyer to pay a higher price for its acquisition.

A banker’s or trader’s responsibilities are nuanced. Depending on the role played (e.g., trading, advising, structuring) and the nature of the client or trade counterparty, the banker may see her duties in a different light.

Thought-Piece: When Does Salesmanship Cross the Line?

In many fixed income markets, unlike in most equity markets, investors have little transparency into prevailing market prices and order flow. Dealers, knowing this, might deceive their clients as to supply and demand in order

---

1 For example, a 1% fee may be inappropriate for moving (or buying or selling) a small allocation of Apple stock; but it may be fair for a trade in an illiquid or complex product, according to which the bank is taking principal risk.

9 If the trader’s counterparty is another dealer or a large asset manager, it may be safe to assume a high level of sophistication. On the other hand, a corporate client engaging in a swap (e.g., to hedge against future market risks) may be less sophisticated, or ill-equipped to decipher between reliable market color and a trader’s puffery.

© Copyright 2016 PF2 Securities Evaluations, Inc. All Rights Reserved.

→ Back to Contents
to maximize their potential for completing trades at profitable levels. Thus, distinct from misrepresenting the truth about an investment itself, there is the potential to misrepresent the truth about the state of the marketplace, or of other competitors’ interest in the sought-after product. Is this standard practice? Is this agreeable or acceptable?

Bloomberg View columnist Matt Levine captured the essence of this dilemma, through the lens of the fortunes of former Jefferies RMBS trader, Jesse Litvak. (In 2014 Litvak was convicted of fraud for lying to his customers about prices paid for bonds he subsequently sold to them, and was sentenced to two years in prison; an appeals court later ordered a retrial because certain evidence had been disallowed at trial.) Levine commented:

“The key question in the Jesse Litvak case is, if a bond trader lies to customers about the price he paid for bonds, is that fraud? These questions are harder than they sound because trading financial products has some analogies to poker, and bluffing and deception are accepted practices in many areas.”

Much like a real-estate agent might try to drum up phantom external interest in a property in order to hurry would-be buyers into making a purchase, so too might bond-traders fabricate competitive interest in order to sell a bond – and the question is whether it is up to the investor to distinguish the true from fictitious demand.

The opacity of the fixed income markets invites these kinds of misrepresentations, because it is difficult for customers to discern if they are being lied to.

In an ongoing criminal case, attorneys for three former Nomura RMBS traders accused of fraudulently misleading customers have filed a motion to present evidence that purports to show that the traders were merely following industry-wide practice by making misrepresentations to customers. A WSJ article highlighted how commonplace it is for fixed income traders to make misleading statements to their customers, citing a trader:

“We’ve always said in this business that there are lies and there are bond lies,” said one veteran mortgage-bond trader … “They’re like white lies. You’re not transacting in a market with grandma…the guy on the other side is doing the same thing.”

Earlier this year, in overturning the criminal conviction of a Midwestern bank employee, the US Court of Appeals for the Seventh Circuit noted poignantly that:

“Negotiating parties, and certainly the sophisticated businessmen in this case, do not expect complete candor about negotiating positions, as distinct from facts and promises of future behavior.”

In a more recent case, Edwin Chin, a former Goldman Sachs RMBS trader, settled civil charges with the SEC over similar misconduct. Chin paid a $400,000 fine and is now barred from the securities industry, neither admitting nor denying the SEC’s findings. Some banks are reportedly making changes, including tighter surveillance and the implementation of mandatory training, in light of the Litvak prosecution.
As discussed above, the twin pressures before financial firms – regulatory costs and revenue weakness – tend to prompt the implementation of short-term fixes, or plugs, and accentuate short-term thinking patterns.

Seeking to grow profits despite these pinch-points, firms are furiously cutting the costs they can. But the worry is that several of the approaches taken will come at the expense of engendering a less physically, intellectually, or emotionally connected workforce that exhibits a reduced interest in the long-term interests of the firm.
Understanding the temptation to cut costs in an environment in which revenue-generation might be constrained, the approaches taken have to be well-considered to avoid alienating employees or exacerbating their innate short-term thinking patterns.

Having already highlighted the detrimental effects of the “IBG-YBG” attitude, the increasing reliance on “temps” or consultants is particularly concerning. By the very nature of the contractual relationship, short-term hires could be expected to be more focused on their own goals and less concerned about their current employer’s policies, its reputation, or its long-term objectives.

In the financial industry, where reputations and customer relationships are hard-earned, a hole can be created when hiring a workforce that sees no further than the tenure of their current contract. We do not suggest that all employees necessarily make better hires than contractors. But short-term personnel, will be less invested in, or loyal to, the companies they temporarily serve: they have little exposure to the upside or downside.

Anticipating a brief tenure, contractors or consultants may be less likely to be methodical about their work or to raise a concern (or a red flag). The “defect rate” can be expected to be higher.

The concern, then, is that the profits sought in replacing W-2s with 1099s may be, like the 1099s themselves, short-term. It may be IBG-YBG, when the next product blows up.

Though some of the present-day cultural initiatives seem novel and exciting in the name of efficiency, they are mostly driven by the drive to cut costs – not the steering of new revenues or the creation of a healthier working environment. Employees recognize this. With “hot-desking,” some employees feel the daily disruption caused by having to locate new seats, familiarize themselves with new environments, or struggle to locate their peers. Many enjoyed the stability of having a dedicated work-station where they could leave their personal belongings each night.

**Framing a Solution**

Our goal here is neither to fully capture the essence of corporate culture, nor to conquer short-termism or its overarching influence on corporate culture. Rather, we seek to home in on the core obstacles we have detailed above, so as to prescribe an approach that is responsive to the challenges faced.

Combating short-termism, or promoting a healthy corporate culture, is a complex task, especially in the financial industry. Finance has traditionally been an “eat what you kill” environment. The very nature of trading appeals to certain types of individuals who may be more focused on their own performance and making money – personalities that are often difficult to manage.
So-called Type A personalities are known to exhibit a healthy competitive drive and an achievement-driven mentality. But they also demonstrate impatience with trivialities and a “free-floating” hostility that can be triggered by minor incidents.

While indecision may frustrate them, they as a group are most responsive to clear direction. With this in mind, a well-articulated approach needs to be communicated: that way personnel can either subscribe to it or leave the firm. And we suggest that the approach needs to address the all-important pay-structure at banks.

One of the impediments is that salaries at financial firms are high (sometimes exorbitantly high), relative to other professions, which in and of itself may prompt more aggressive behavior. It is seen in Western cultures as a measure of success and power to be paid handsomely, bringing with it a sense of bravado, while perpetuating a mindset courageous decision-making. Moreover, many in finance measure the value of their performance by how well they are compensated, whereas in other professions one’s self-worth is often validated through other, less explicitly financial, means.

Any lowering (or even adjusting) of compensation packages can therefore be a particularly thorny topic to address.

But cultures can be modeled to limit the potential for bombastic tendencies being overplayed. Australia has a term, “the tall poppy syndrome,” for their culture of discrediting any classification of others as better; the Scandinavian “Law of Jante” refers to a mentality that de-emphasizes individual effort and places emphasis on the collective, and is communicated in the form of coarse rules, including: “You’re not to think you are smarter than we are.” And “You’re not to convince yourself that you are better than we are.” Successful sporting teams, too, often encourage a culture of humility to engender a team environment in which all players are responsible to one another. We are not saying that individual success should not be rewarded; but rather that current reward levels sometimes fail to appropriately recognize, or are disconnected from, the support network that enabled it.

There are several ways for companies to more appropriately link pay to performance. Banks are instituting claw-back provisions: they can recoup some or all of bonuses paid if, in the future, they find that the revenues that bonuses were premised on were fleeting. Similarly, bonuses are being deferred in an effort to ensure that trades are constructed to be profitable over time – not just to generate a quick “accounting” gain that triggers a phantom profit.

Some banks have deployed creative compensation structures, linking bonuses to the future performance of the firms (or their assets). In 2008 Credit Suisse began an arrangement in which it would pay a portion of bonuses via a share in troubled assets – securities and loans that were deemed “toxic” and were trading at distressed levels. Some of UBS employees’ 2012 bonuses were paid in the form of contingent capital bonds, which can be wiped out if the firm’s common equity ratio falling below 7%. Other variations could include the payment of bonuses in the form of company debt, with the idea that debt holders may be more thoughtful than equity holders about the taking of out-sized risks.

Executive remuneration schemes can also be tied to risk-adjusted profits, which would account for the amount of risk inherent in a bank’s or group’s business model or product mix. Other measures include linking executive pay to reputational improvements or levels of customer satisfaction, which will focus managers on the longer-term goals.

---

During periods of economic expansion, most bank CEOs earn bonuses in the tens of millions of dollars, only to watch their compensation packages dwindle in a down-cycle. The question naturally follows: Were the executives all such strong performers during the up-cycle, or was the economic cycle itself the explanatory variable in the banks’ profits?

---

h In Japan, for example, there is a stigma – a social penalty – associated with a high pay package. (See, for example: http://www.economist.com/news/business/21703430-japanese-bosses-still-find-it-hard-ask-more-pay-check)
An Approach to an Approach

The concept “high-risk = high reward” is widely misunderstood and misapplied. If it always worked, everybody would take more risk. One does earn a higher reward from when high risks pan out: but they must pan out. This forms the basis for the maxim we suggest.

The approach we put forward here is the studious linking of profit-sharing to successful and honest risk-taking and business practices.

The Wells Fargo saga reminds us that short-term and aggressive quota-setting approaches are not the way to go. Among other things, once well defined, measures that are difficult to achieve (but crucial to performance) are more likely to be gamed. Healy and Niven explain their finding that “participants who were given a specific performance goal for how much revenue they had to earn were almost twice as willing to use unethical methods to achieve it than those given a vague goal, irrespective of their moral justification.”49

Rather that setting short-term goals measured according to short-term success, we propose an alternative mechanism that we hope captures several important considerations: (1) that the profit-recognition and allocation of compensation among team members be based on decisions successfully panning out; (2) that the risks taken must have been honestly taken; and (3) that profits be based on the implementation of proper and prudent business practices, and shared with those team members who instituted them.

With each member’s incentives linked to the firm’s success and reputation – its overall achievement can be quantified as an important metric – one’s colleagues’ concerns become more relevant. When traders profit from taking honest risks and adhering to well-conceived standards for risk and compliance, the risk and compliance professionals can directly enjoy the benefits too. Conversely, if traders transgress, after ignoring poorly-constructed, vague or undefined protocols, then risk and compliance personnel can suffer too. After all, they have not performed their jobs well or achieved their goals.

There are intricacies that need to be properly considered in implementing a more holistic approach, and we are not suggesting it will be easy. For one, it may seem ideal to include risk managers in the upside of successful and honest risk-taking by the front-office producers. Right now, they conceptually have little incentive to agree to any real risk-taking, having no upside if risks generate rewards, but all of the downside when risks taken go sour. But including risk managers in the upside can have its consequences too: if the incentives are not well constructed, risk managers might become more prone to risk-taking than might otherwise be ideal.

If appropriately executed, this framework can culminate in a different attitude among team members:

- Once team members begin to appreciate that their colleagues will share in their profits or losses, they will be more likely to supervise or cooperate with one another, share ideas, and trigger alerts.
- Rogue traders will be stigmatized once their trades directly influence, in a quantifiable way, the take-home pay of fellow team members (or require bonus claw-backs), discouraging unwanted behavior.
- Rather than middle- and back-office functions (reconciliations, risk and compliance) being a foreign annoyance to the front-office, they can be cast as part of a shared responsibility.

Ultimately, a holistic approach works to the degree it brings personnel together, creating a firm-wide culture. It may work best under a different definition of success: a definition that considers the long-term goals of the companies and the teamwork involved in the decision-making processes.
This research piece considers some of the practical issues and environmental themes, within financial firms, that can make the designing of a corporate culture all the more challenging. We have not sought to provide a comprehensive or complete depiction, and have left out several elements worthy of consideration.

PF2 Securities’ research team focuses on the dynamics of fixed-income, currencies, and commodities trading markets. We are typically engaged in the context of dispute resolution or litigation to explain market norms from a practitioner’s perspective, build or apply mathematical models and statistical techniques to analyze (potentially anomalous) market movements and patterns, and to quantify potential damages from any agreed-upon wrongdoing.

PF2 Securities has offices in New York, Los Angeles, and Sydney. For North American or European matters, email us at info@pf2se.com, or for Australian matters at info@pf2se.com.au. You can join our distribution list by signing up on the News & Research page of our website.

PF2 is an independently-held consulting company. We do not provide investment, legal, tax or any other advisory services.

Disclaimer

This research report provides an overview of several of these larger themes in financial markets litigation, but it does not aim to be comprehensive as much as illustrative. It is provided for information purposes only and should not be construed to constitute a solicitation, recommendation or offer to buy or sell these securities or financial instruments in any jurisdiction, or an official confirmation of any transaction, or as an official statement of PF2 Securities Evaluations, Inc. (PF2). Information contained herein may be obtained by PF2 from sources believed by it to be accurate and reliable. No representation or warranty, either express or implied, is provided in relation to the accuracy, completeness or reliability of the information contained herein. PF2 does not undertake that investors will obtain profits, nor will it share with investors any investment profits nor accept any liability for any investment losses. Investments involve risks and investors should exercise prudence in making their investment decisions. PF2 does not provide accounting, tax or legal advice. All information contained herein is protected by copyright law and may not be copied or otherwise reproduced, repackaged, transferred, redistributed or resold for any purpose, in any shape or form, without PF2’s prior written consent.
## Pricing/Valuation Probes and Investigations

<table>
<thead>
<tr>
<th>Date</th>
<th>Issue</th>
<th>Link(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>August 2016</td>
<td>Some mutual funds, including Hartford Growth Opportunities Fund, have reportedly been increasingly reliant on rich private company valuations to boost returns. Meanwhile, the SEC is reportedly focusing on private-company valuations as part of its reviews of asset management firms.</td>
<td><a href="http://www.reuters.com/article/us-funds-valuations-idUSKCN10M0CP">http://www.reuters.com/article/us-funds-valuations-idUSKCN10M0CP</a> <a href="http://on.wsj.com/1WYIE6z">http://on.wsj.com/1WYIE6z</a></td>
</tr>
<tr>
<td>July 2016</td>
<td>The DoJ and SEC are investigating Platinum Partners for potentially mismarking complex and illiquid assets, including California oil fields with questionable prospects for significant production. “Those impressive returns came from esoteric and hard-to-value investments such as life insurance policies of people who were on the brink of dying and risky energy bets.”</td>
<td><a href="http://nypost.com/2016/07/31/hedge-fund-tied-to-kickback-probe-used-checkered-valuation-firm/">http://nypost.com/2016/07/31/hedge-fund-tied-to-kickback-probe-used-checkered-valuation-firm/</a></td>
</tr>
<tr>
<td>July 2016</td>
<td>“LendingClub ... said in the filing that LC Advisors hadn’t followed standard accounting rules when it was determining the value of the loans in its portfolio as well as their monthly returns.”</td>
<td><a href="http://bit.ly/2cjs7oT">http://bit.ly/2cjs7oT</a></td>
</tr>
<tr>
<td>June 2016</td>
<td>Alden Global Value Recovery Master Fund, an investor in JPMorgan Chase Commercial Mortgage Securities Trust, 2007-CIBC18, has sued the deal’s master and special servicer (Berkadia Commercial Mortgage and KeyBank, respectively) for the “flawed” appraisal of a loan sold by the CMBS trust. Alden claims that Cushman &amp; Wakefield, the 3rd-party appraiser, incorrectly used discount and terminal rates that were too high, and that comparable sales and land value were not properly incorporated, among other objections.</td>
<td><a href="https://iapps.courts.state.ny.us/lbem/DocumentDisplayServlet?documentId=T9_PLUS_14M/8YL35sZTPE1YZdG==&amp;system=prod">https://iapps.courts.state.ny.us/lbem/DocumentDisplayServlet?documentId=T9_PLUS_14M/8YL35sZTPE1YZdG==&amp;system=prod</a></td>
</tr>
<tr>
<td>March 2016</td>
<td>Portfolio managers at Visium Asset Management were accused of: (1) Fraudulently mismarking as many as 28 securities per month by using sham (non-independent) broker quotes to override valuations from established pricing sources; and (2) marking up existing bond positions by purchasing additional amounts of the bonds at above-market prices near month-end.</td>
<td><a href="https://www.justice.gov/usanysny/file/867231/download">https://www.justice.gov/usanysny/file/867231/download</a> <a href="https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-lumiere.pdf">https://www.sec.gov/litigation/complaints/2016/comp-pr2016-119-lumiere.pdf</a></td>
</tr>
<tr>
<td>February 2016</td>
<td>Some business development companies (BDCs), including Prospect Capital, were found to have written down some illiquid securities (e.g., CIFC Funding-2014-IV, a CLO) at a slower pace than other BDCs.</td>
<td><a href="http://www.wsj.com/articles/loan-valuations-draw-scrutiny-1455237154">http://www.wsj.com/articles/loan-valuations-draw-scrutiny-1455237154</a></td>
</tr>
<tr>
<td>September 2015</td>
<td>A Canadian pension fund sued Saba Capital, claiming the hedge fund mismarked assets and changed its valuation methodology for certain securities to lower the hedge fund’s NAV at the time of the pension fund’s large redemption. For example, according to the complaint filed, instead of its usual practice of using external pricing sources, Saba used bids-wanted-in-competition (“BWICs”) to price a certain position (corporate bonds issued by The McClatchy Company), even though Saba was not selling the bonds. The BWICs resulted in a valuation of 31, versus a range of 50-60 via the external pricing sources, thereby suppressing the fund’s NAV. After the investor redemption, Saba purportedly resumed using external pricing sources to price the McClatchy bonds.</td>
<td><a href="http://www.forbes.com/sites/antoinegan/a/2015/09/25/canadian-pension-fund-says-it-was-cheated-by-boaz-weinsteins-saba-capital/#30b3b5787506">http://www.forbes.com/sites/antoinegan/a/2015/09/25/canadian-pension-fund-says-it-was-cheated-by-boaz-weinsteins-saba-capital/#30b3b5787506</a></td>
</tr>
</tbody>
</table>
Addendum 2

Structuring, Trading & Execution Issues

<table>
<thead>
<tr>
<th>Date</th>
<th>Issue</th>
<th>Link(s)</th>
</tr>
</thead>
</table>
| August 2016| "An SEC investigation found that Edwin Chin generated extra revenue for Goldman by concealing the prices at which the firm had bought various RMBS, then re-selling them at higher prices to the buying customer with Goldman keeping the difference."
| May 2016   | "Merrill Lynch, Pierce, Fenner & Smith, a subsidiary of Bank of America (BAC), was ordered to pay $422,708 in fines and restitution by the Financial Industry Regulatory Authority for charging customers excessive markups and markdowns on municipal securities."                                                                 | https://fixedincome.fidelity.com/ftgw/fi/FINewsArticle?id=201605161905SM___BNDBUYER_0001103826_11.1                                                                                              |
| July 2016  | "State Street admitted that contrary to its representations to certain custody clients, its State Street Global Markets division (SSGM) generally did not price FX transactions at prevailing interbank market rates. Instead ... SSGM executed FX transactions by applying a predetermined, uniform mark-up ... or mark-down ... to the prevailing interbank rate for FX. State Street is also alleged to have falsely informed custody clients that it provided “best execution” on FX transactions, that it guaranteed the most competitive rates available on FX transactions and that it priced FX transactions based on a variety of factors when, in fact, prices were largely driven by hidden mark-ups designed to maximize State Street’s profits."
| August 2015| "An SEC investigation found that instead of offering bonds to customers at the initial offering price, Edward Jones and Stina R. Wishman took new bonds into Edward Jones’ own inventory and improperly offered them to customers at higher prices."
| May 2015   | JPMorgan Chase, Citigroup, and BNY Mellon have been sued by ADR investors for charging unauthorized fees and converting foreign dividends at unfavorable FX levels. The cases are ongoing.                                                                 | http://nypost.com/2015/07/18/banks-are-ripping-off-investors-in-overseas-markets/                                                                                                                             |
| March 2015 | "... BNYM admits to and accepts responsibility for conduct alleged in the civil fraud lawsuits, including that contrary to representations to clients that it provided 'best rates' and 'best execution,' the Bank actually gave clients the worst reported interbank rates of the trading day."
### Key

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>bn</td>
<td>billion</td>
</tr>
<tr>
<td>mm</td>
<td>million</td>
</tr>
<tr>
<td>AML</td>
<td>Anti-Money-Laundering</td>
</tr>
<tr>
<td>ASIC</td>
<td>Australian Securities &amp; Investments Commission</td>
</tr>
<tr>
<td>AUM</td>
<td>Assets Under Management</td>
</tr>
<tr>
<td>BWIC</td>
<td>Bid-Wanted-In-Competition</td>
</tr>
<tr>
<td>CCAR</td>
<td>Comprehensive Capital Analysis and Review</td>
</tr>
<tr>
<td>CDO</td>
<td>Collateralized Debt Obligation</td>
</tr>
<tr>
<td>CS</td>
<td>Credit Suisse</td>
</tr>
<tr>
<td>DoJ</td>
<td>U.S. Department of Justice</td>
</tr>
<tr>
<td>FASB</td>
<td>Financial Accounting Standards Board</td>
</tr>
<tr>
<td>FCA</td>
<td>Financial Conduct Authority</td>
</tr>
<tr>
<td>FCIC</td>
<td>Financial Crisis Inquiry Commission</td>
</tr>
<tr>
<td>FICC</td>
<td>Fixed-Income, Currencies and Commodities</td>
</tr>
<tr>
<td>FSA</td>
<td>Financial Services Authority</td>
</tr>
<tr>
<td>FX</td>
<td>Foreign Exchange</td>
</tr>
<tr>
<td>HFT</td>
<td>Higher Frequency Trading (or Trader)</td>
</tr>
<tr>
<td>HQLA</td>
<td>High-Quality Liquid Assets</td>
</tr>
<tr>
<td>LCR</td>
<td>Liquidity Coverage Ratio</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Interbank Offered Rate</td>
</tr>
<tr>
<td>MSR</td>
<td>Mortgage Servicing Right</td>
</tr>
<tr>
<td>NAV</td>
<td>Net Asset Value</td>
</tr>
<tr>
<td>NIM</td>
<td>Net Interest Margin</td>
</tr>
<tr>
<td>NY DFS</td>
<td>New York Department of Financial Services</td>
</tr>
<tr>
<td>OTC</td>
<td>Over-The-Counter</td>
</tr>
<tr>
<td>P&amp;L</td>
<td>Profit(s) and Loss(es)</td>
</tr>
<tr>
<td>PRA</td>
<td>Prudential Regulation Authority</td>
</tr>
<tr>
<td>RMBS</td>
<td>Residential Mortgage-Backed Security(ies)</td>
</tr>
<tr>
<td>S&amp;P</td>
<td>Standard &amp; Poor’s</td>
</tr>
<tr>
<td>SEC</td>
<td>U.S. Securities and Exchange Commission</td>
</tr>
<tr>
<td>SEF</td>
<td>Swap Execution Facility</td>
</tr>
<tr>
<td>SIV</td>
<td>Structured Investment Vehicle</td>
</tr>
<tr>
<td>SocGen</td>
<td>Société Générale</td>
</tr>
</tbody>
</table>
Endnotes

4 The People of the State of California vs. Wells Fargo & Company, et al. BCS80778
8 http://www.wsj.com/articles/peter-thiel-competition-is-for-losers-1410535536
10 https://www.americanactionforum.org/insight/six-years-dodd-frank-higher-costs-uncertain-benefits/
13 http://www.bis.org/publ/bcbs238.pdf
14 https://www.bis.org/bcb/publ/d352_note.pdf
15 http://www.investopedia.com/terms/n/netinterestmargin.asp
16 No matter how high or low interest rates go, a non-interest bearing deposit still costs the bank 0% in interest expense, meaning that portion of a bank’s borrowings does not become cheaper with lower interest rates, while all of a bank’s earning assets are affected by overall interest rate levels. There is some disagreement regarding the importance to banks of the slope of the yield curve, with many arguing that a flat yield curve (all else equal) is detrimental to NIM. To the extent that fixed-rate loans are priced off of the 10-year Treasury yield, this would seem to hold. However, with many commercial loans referencing LIBOR or other short-term rates, the flatness or steepness of the yield curve would seem to be less critical to NIM. Either way, the overall level of interest rates (both short-term and longer-term) directly affects NIM.
23 http://www.reuters.com/article/us-usa-banks-outlook-idUSKCN0VI1DM
27 The FSA evolved into the FCA and the PRA. FSA letter, addressed Dear CEO, on the topic of “Remuneration policies,” October 13, 2008.
30 http://people.stern.nyu.edu/igiddy/ABS/fasb140.pdf
31 The case, Morrison v. National Australia Bank, later became quite an important case concerning the extraterritorial jurisdiction of U.S. securities litigation, argued before the Supreme Court in 2010.
32 Shareholder Report on UBS’s Write-Downs, April 18, 2008
34 Investors can account for anticipated asset writedowns by valuing bank shares at less than book value.

© Copyright 2016 PF2 Securities Evaluations, Inc. All Rights Reserved.

→ Back to Contents
For example, the New Zealand rugby side (the “All Blacks”) is known to hold “personal humility” among its cardinal values. In perpetuating this mentality, they have a system of “sweeping the sheds”: tidying up after themselves at the end of each game. The All Blacks are considered to be among the greatest sporting teams on record (across all sports).