BANKING GOVERNANCE & CULTURE

Creating Wealth & Societal Value in the Global Banking Sector

Morgan Stanley

Deutsche Bank

JPMorgan Chase & Co.

An Organizational Maturity Services LLP report for and on behalf of the Maturity Institute

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About the Maturity Institute

The Maturity Institute (MI) is a professional body whose purpose is to help create good governance and healthy organizations that generate the most societal value and greatest returns possible from the world's human capital. We define societal value, unequivocally, in terms of Outputs, Cost, Revenue and Quality (OCRQ) and measure it using the composite of Total Stakeholder Value (TSV[i]), which specifically incorporates any organizational costs relating to undue, external harm.

To create TSV, we have developed a revolutionary approach to raising the level of professionalism in organizational leadership and management practice. To date, there have been no universal, professional standards set for corporate governance, organizational health and culture that can guide leaders, executives and general management to operate from an evidence-base that is analogous to the highest standards of the medical profession. TSV is part of a suite of MI's global standards that are filling this gap.

It is self-evident that a corporation cannot maximize its own value if it does not endeavour, strategically, to maximise the value of every single person in it or connected with it. This is the premise on which our Organizational Maturity Ratings (OMR) scale is founded and against which organizations are assessed. Furthermore, we recognize that we cannot set meaningful, practical standards unless we offer the means by which they can be measured and improved. This is why we developed our global Organizational Maturity Index (OMINDEX), based on the OMRs of each organization.

The OMR rating process is based on a set of questions, the OM30©, which covers all key components of value creation e.g. corporate purpose, values, principles, governance, strategy and operational effectiveness. OM30© has intrinsic value for boards and executives in understanding whole system value creation as it produces a complete picture that explicitly and causally links organizational health to material value and risk. MI's aim is for the OM30© to become integral to company auditing and reporting; either as part of a Form 10K, annual report or similar format.

In setting new standards, we carry out projects to analyse how specific sectors are performing. Our Banking Governance & Conduct Project is the most significant to date.

We plan similar projects for all of the other main sectors of the corporate world and we are actively engaging with organizations that need help with reconciling their financial goals, and shareholder demands, with the

legitimate concerns of society around governance and culture. We welcome confidential enquiries from any organization wishing to explore what opportunities can be gained from embarking on a journey of personal, professional and organizational maturity.

Paul Kearns
Chair,
Maturity Institute

June 2017

Banking Governance & Culture: Project Rationale and Methodology

> *"…I will confess I understand little about how corporate cultures work or how to improve them. . I think I understand money pretty well; culture puzzles me. But culture is there and it matters."* **Robert Armstrong, Senior Economics Correspondent, Financial Times, 2017**

The rationale for this project starts with several of the most serious and universal questions that conventional leadership, management and business schools are debating but have so far failed to answer:

- How can we forge an enlightened, market-based, capitalist system that best reconciles the needs of all the world's stakeholders with the financial valuation of corporations?
- How can we assure good governance that serves the best interests of society as a whole?
- How can we measure corporate culture as a means of encouraging, managing and improving organizational health through the best of corporate actions and behaviours?

These questions are not new but have gained unprecedented traction in recent decades; particularly since the global financial crisis (GFC) of 2008, where they have become especially pertinent to the global banking sector.

Of course, banking does not exist in a vacuum so we have to take a whole system perspective to include all of the relevant professional bodies and authorities tasked with its control and management. This approach has resulted in a specific set of questions that this report aims to answer:

1. Have any of the banks performed better since the GFC in 2008?
2. Has there been any discernible, positive shift in the sector's corporate responsibility?
3. Is banking culture any healthier now?
4. Have any fundamental lessons been learned about governance and culture?
5. Do the banks' Chairs and CEOs exhibit any greater integrity?

6. Do the banks pose less risk to stakeholders?
7. How can the banks improve their risk management capability?
8. Do banks have the necessary capability for rising to these challenges and, if not, where can they turn for solutions?
9. Can we envisage a future where banks will serve all stakeholders' legitimate expectations?

Banks rated for the Banking Governance and Culture Project

Bank of America
Banco Santander
Barclays*
BNP Paribas
Citigroup
Commerzbank AG
Credit Suisse
Deutsche Bank*
Goldman Sachs*
Handelsbanken*
HSBC*
ING
JPM Morgan Chase
Lloyds Banking Group*
Morgan Stanley
National Australia Bank
Royal Bank of Scotland*
Societe Generale
Standard Chartered Bank*
UBS
Wells Fargo

How were the banks chosen?

The above banks were originally placed at the top of an international league table in order of their misconduct costs. Estimates for the five years to 2015 identified that £252bn in fines had been accumulated by the top twenty global banks. The only exception in our chosen group is Handelsbanken, which was already a highly rated MI exemplar, and specifically included here for benchmark comparison purposes.

All of the asterisked banks were originally rated for OMINDEX between 2015 and 2016 and have been re-rated in 2017 for the purposes of this project. All other banks shown were OMR rated in 2017 for the first time.

Each bank's respective position on OMINDEX reveals how they compare in absolute and relative terms with respect to their Governance and Culture and how that is causally linked to their Total Stakeholder Value (TSV) scores.

The OMINDEX Methodology

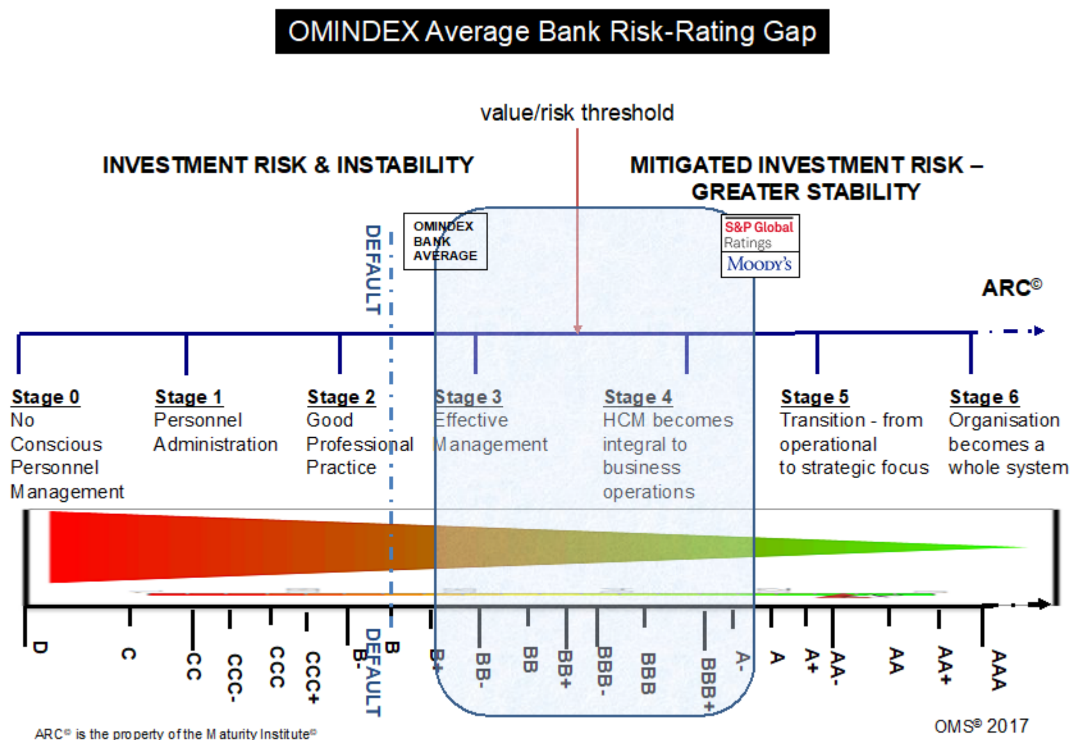

Figure 1. The OMINDEX Rating Scale measures human capital value realization and people risk

This report is based on the application of our OM30© instrument to generate an Organizational Maturity Rating (OMR©) for each bank on a maturity scale with 22 gradations (from AAA to D). This scale mirrors the Standard & Poor's credit rating scale and is specifically designed to sit alongside traditional, financial ratings.

The OM30© views banks both as whole systems, in their own right, as part of the whole banking system and a key sector in the world's economic system. It is designed to capture all of the key components that, together, create an organization with an optimal combination of social legitimacy and exceptional financial performance.

The original exemplar for this methodology was Toyota Motor Corporation, which is now universally regarded and respected as the de facto standard in manufacturing excellence. What has not been so widely recognized or understood is Toyota's highly sophisticated approach to governance and culture; where human capital remains the most important ingredient for competitive advantage and sustainable success. This constitutes a whole system formula that is extremely difficult for peers to replicate.

For example, the huge disparity between the market values of Ford, General Motors and VW, when compared to Toyota, has been built over the long term and is now unassailable. These same lessons will apply equally to the banking sector as the mature exemplars steal a march on their immature competitors. We confidently predict that any banks which fail to learn important lessons about how value emanates from effective governance and a heathy corporate culture (G&C), will suffer accordingly in terms of likely future performance and market value.

In summary, this comprehensive report provides in-depth coverage of the critical G&C issues that are material, not only to the 21 banks selected, but the whole of the global banking sector. This includes all related professional advisers, regulators, asset owners and asset managers.

Our review incorporates an assessment of legitimate corporate purpose, leadership quality, management capability, decision-making, human capital utilization and innovation. It also offers insights into associated but particularly thorny issues such as banking regulation, executive pay and diversity.

OMINDEX: Bank Ranking Table

Our overall OMINDEX ranking of the banks based on their OMR (and associated percentage scores) is shown in Table 1. Two key positions on the scale are of special importance:

Value & Risk Threshold (BBB-)

This signifies the point at which the board and executive suite demonstrate a recognition and understanding of the material value of the causal connections between corporate governance, human governance, and human capital management (see also Figure 1.).

Below this threshold, corporations erroneously regard and manage human capital primarily as a source of cost for the business. Banks that fail to cross this threshold remain sub-optimal in the short term. In the long-term, with other factors remaining constant, their relative competitive position will decline and deteriorate as more mature peers build competitive advantages that become increasingly difficult to replicate.

Bank	OMR
Handelsbanken	AA-
ING	A-
Goldman Sachs	A-
Santander	BBB
▲ Above 'Value & Risk' Maturity Threshold ▲	
National Australia Banking Gp	BB+
Commerzbank AG	BB+
Morgan Stanley	BB+
Bank of America	BB
Lloyds Banking Group ORD	BB
Credit Suisse	BB
UBS	BB-
Deutsche Bank	BB-
Royal Bank of Scotland Gp	BB-
Citigroup	BB-
Wells Fargo	B+
Standard Chartered	B+
BNP Paribas	B+
HSBC Holdings	B+
▼ Default or lower ▼	
JP Morgan Chase	B
Societe Generale	B
Barclays	CCC+

Table 1. OMINDEX: Bank rankings

Default 'B' Rating

This reflects a rating primarily aligned with the low value of conventional human capital management practice; generally informed by operationally focused HR functions guided by so called "best practice". Such management practices are not based on any value/risk standards or assessments; nor are they predicated on a coherent, evidenced-based philosophy. Such corporations are therefore unable to understand or leverage any causal connection between human capital management practice and material value and risk.

It should be noted that all the banks analysed follow similar "HR" conventions. The difference between high and low OMR scores reflects the maturity of the organisation's whole operating environment, not its HR function. For example, headcount reductions can be administered by HR teams in both immature and mature environments: in the former, this would be a simplistic cost reduction exercise, in the latter, we would expect a fuller evaluation of the wider value (OCRQ) impact.

The Top 12 Material Value and Risk items

1. Across the 21 banks on this project the combined, operating income in excess of $250 billion is the result of a generally low maturity level across the sector. This can be improved significantly. Our experience and evidence shows companies with such low levels have the potential to generate a 5-10% point operating margin improvement. If the entire group of 20 achieved the 50% operating margin of top-rated Handelsbanken it would double current operating income levels to $500bn.

2. Even a very modest 1% improvement in operating income is worth at least $2.5 billion across the 21 banks. Our view is that an aggregate investment of c.$100 million across this rated group would improve OMINDEX ratings to generate operating income improvement and returns well in excess of the 1% investment.

3. Our analysis in Figure 2. provides further evidence to validate a clear relationship between higher OMINDEX ratings and price to book ratios for the 21 banks rated.

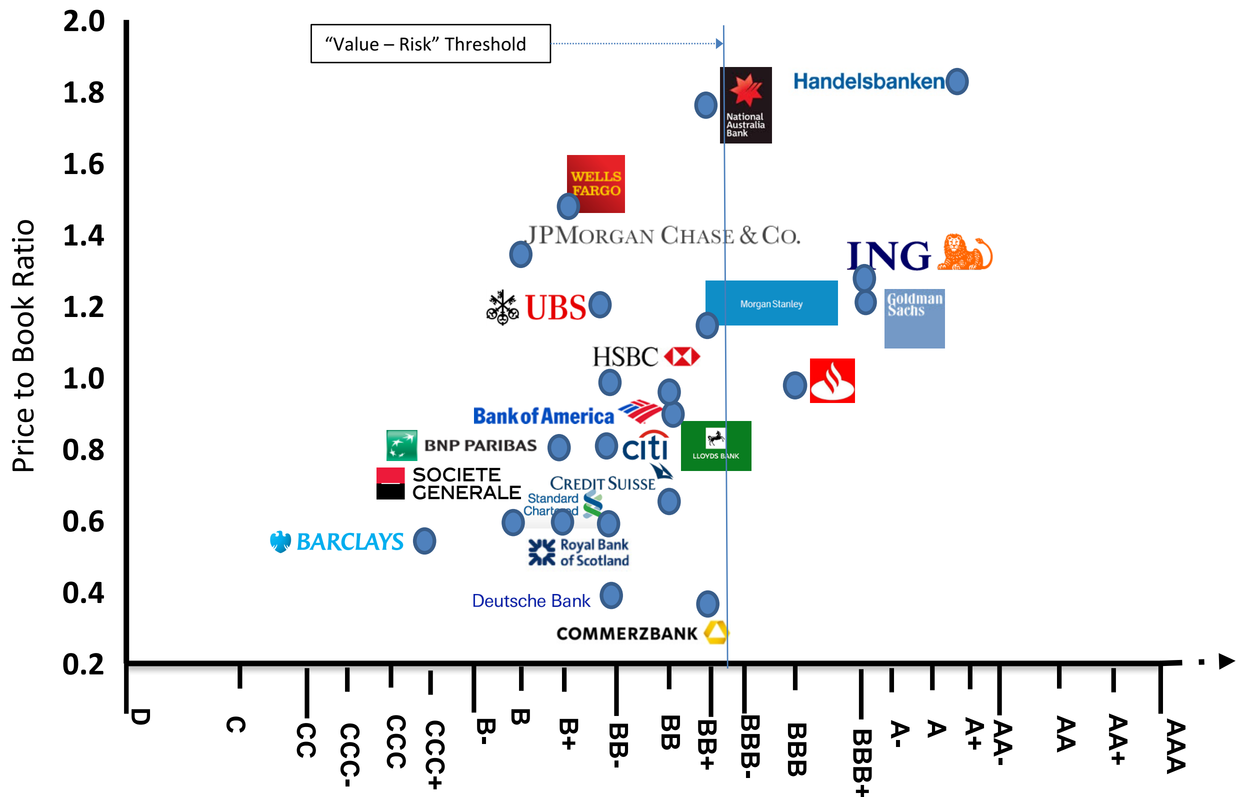

Figure 2. OMINDEX shows G&C matters to long-term market value

OMINDEX ratings and P/B ratios valid as at May 2017

4. Our banking OMINDEX currently predicts that the high level of G&C risk being carried by most banks in our group is presently generating a material and detrimental value impact, largely through unseen value erosion. In risk parlance, this can be described as “severe”, which suggests that a Wells Fargo type failure may arise again at any time, even in the absence of any visible, imminent threat.

5. The evidence also demonstrates that conventional credit rating provides limited insight into current and future corporate health and value. Most banks remain ‘creditworthy’ despite the continued incidence of material misconduct causing damaging and potentially fatal outcomes e.g. Deutsche Bank (S&P A-, OMINDEX BB-), Wells Fargo (S&P A, OMINDEX B+).

6. The major US banks (JP Morgan Chase: OMR ‘B’, Wells Fargo: ‘B+’, Bank of America: ‘BB’, Citigroup: ‘BB-‘) and their UK equivalents (HSBC: B+, Barclays: CCC+, RBS: BB- and Lloyds: BB) may be deemed ‘too big to fail’ in their respective jurisdictions but this has to be set against their worryingly low OMINDEX ratings, suggesting risk to future creditworthiness. Are they too immature?

7. These low US and UK bank ratings have significant implications for their relative abilities to succeed against higher-rated competitors and, in risk terms, for their societal stakeholders. In the absence of any change, the evolution of more mature banks across the globe could have a similar impact on US (and UK) banking as Toyota had on US (and UK) automotive manufacturing since over the last 80 years.

8. The human capital within the 21 banks covered by this project amounts to a reported total of 2,442,232 employees. None of the banks currently have a system for capturing their ideas and innovations to the MI standard (where one idea per employee, per year, equates to 100%). This represents a huge underutilization of human capital potential with a subsequent loss to society of the same magnitude.

9. The global banking sector cannot be accurately described as a banking system. The banking authorities and regulators within the jurisdictions covered by this project do not currently have the capability for transforming this disparate group of banks into an effective system. This report provides a framework on which to build a robust and socially legitimate banking system for the future.

10. The OMR scores of the 21 banks on the project ranges from 23.9% (Barclays) to 82.6% (Handelsbanken) with an average of 48.5%. This is below the threshold at which boards and C-suites can be deemed to be mature (see Figure 1.). As ratings increase, each bank with a higher

rating has an increasingly differentiated approach to human governance and managing human capital.

11. Cost efficiency (see Table2): few banks articulated a coherent strategy to link human capital and cost efficiency: Banco Santander and Handelsbanken were notable exceptions. There is little evidence that human capital is incentivised or managed to drive and support a positive cost control culture. We see an obvious opportunity here to engage and align all human capital in systematic, ongoing cost improvement.

Table 2	**Bank Cost/Income ratios**
National Australia Banking Gp	41.60%
Handelsbanken	45.20%
Lloyds Banking Group ORD	47.10%
Santander	48.00%
ING	54.20%
Royal Bank of Scotland Gp	55.80%
Citigroup	58.00%
Wells Fargo	61.20%
HSBC Holdings	63.20%
JP Morgan Chase	65.17%
Societe Generale	65.60%
BNP Paribas	68.13%
Bank of America	71.16%
Goldman Sachs	72.00%
Barclays	72.00%
Standard Chartered	72.60%
Commerzbank AG	75.50%
Morgan Stanley	79.99%
UBS	81.00%
Credit Suisse	83.00%
Deutsche Bank	98.10%

Table 2. Cost/income ratios

12. Most banking CEO and executive remuneration systems (sic) remain driven primarily by short-term financial targets and are not adequately aligned to key value and risk drivers as defined by our global standard of Total Stakeholder Value (TSV). Only 3 banks managed to produce a credible link between CEO pay and TSV as per the chart in Figure 3. below.

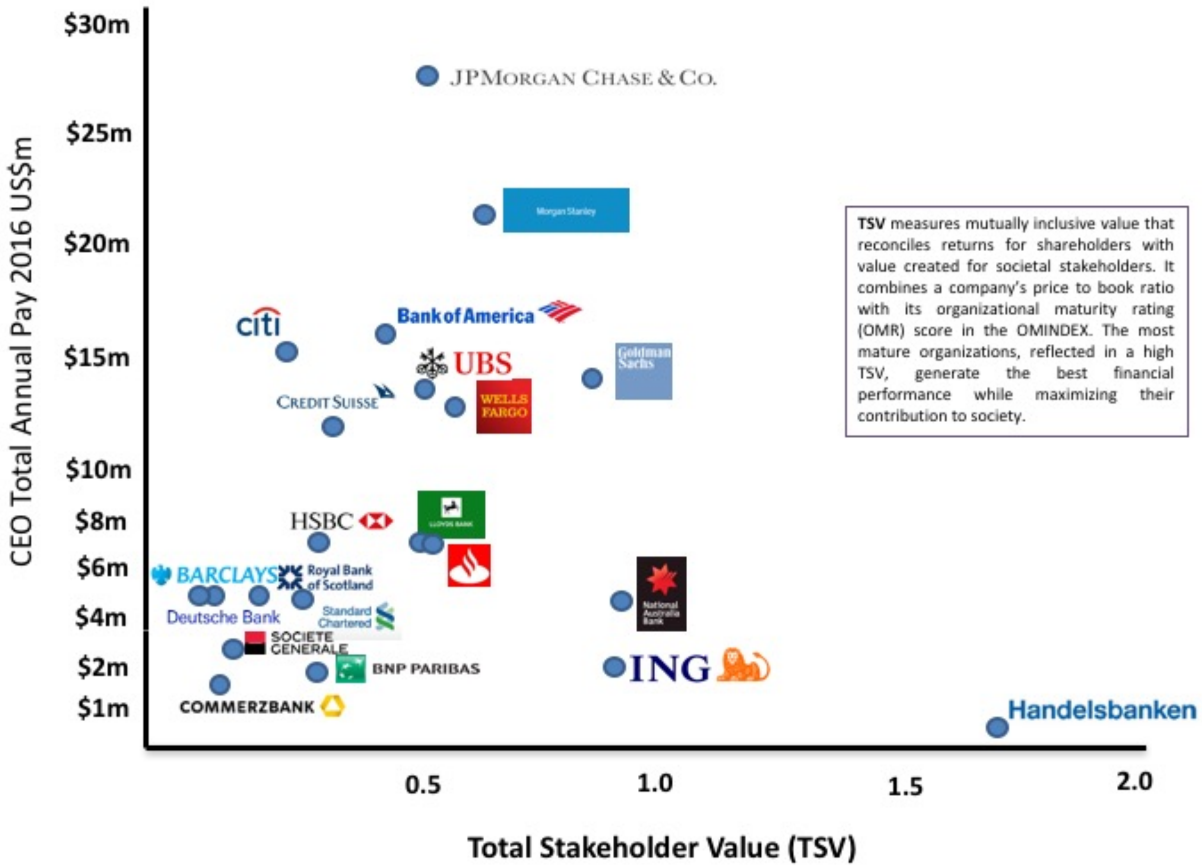

Figure 3. CEO pay and Total Stakeholder Value

Our summary findings

"Banking is undergoing disruption as never before. Together with the pace of change in the world around us, this creates uncertainty regarding the way forward...we have the ability to adapt and succeed in this new environment so we can continue to meet the needs and expectations of customers and society and play an important role in building a sustainable and prosperous future for all."

Ralph Hamers, CEO ING, ING 2016 Annual Report

Structure

1. Many banking organizations are fragmented franchises that have arisen from relatively recent acquisitions. With one or two exceptions, the banks that are operating such fragmented systems do little to acknowledge or manage this. This creates a significant barrier for coherent governance and cohesive culture to arise and support value generation and better risk management.

Board capability

2. Some banks have organized board committees and responsibilities to oversee G&C improvement. There is little evidence that such initiatives have made substantive improvements in organizational health.

3. Those banks with stronger and more effective boards and senior leaders are characterized by strategic coherence: from a clarity of purpose, embedded values and the alignment of all human capital associated with the organization working towards common goals.

4. We view domain knowledge[ii] as critical at leadership level. However, in the wake of the GFC of 2008, and more generally within the context of the current business paradigm (characterized by a short-term, shareholder return mindset), we observe a dearth of appropriate C-suite talent who have the capability to effect the necessary changes and manage TSV in the right direction. Even our highest-rated bank, Handelsbanken, has found difficulty in finding the right CEO, highlighting the need to revisit C-suite talent assessment and selection.

Risk

5. All banks have invested heavily in more robust compliance functions and risk management processes. Many are, however, relying on these to protect them from G&C risk. Ultimately our view is that *culture* can either work against (and ultimately override) or support control

systems. Only a small number of banks have both understood this and are developing cultures that can create the latter outcome.

6. G&C is critical to both value creation and risk management but management systems must be specifically designed for the clear purpose of creating a culture of effective risk management throughout a bank. Our four most highly-rated banks understand this critical attribute and the mechanisms necessary to ensure knowledge sharing, collegiate decision-making and open communication. This combination is best suited to aligning business behaviour with underlying purpose and values. Consequently, their OMR Risk Factor is significantly lower.

7. Overall, we have found the existence of significant gaps (an average of 5.5 gradations) between conventional credit ratings and OMINDEX ratings (see Figure 4.) OMINDEX is specifically designed to offer a forward-looking indicator of organizational health. Consequently, the magnitude of this risk-ratings gap should be of concern to all stakeholders (see Appendix 1. for Banco Santander risk-ratings as an example.)

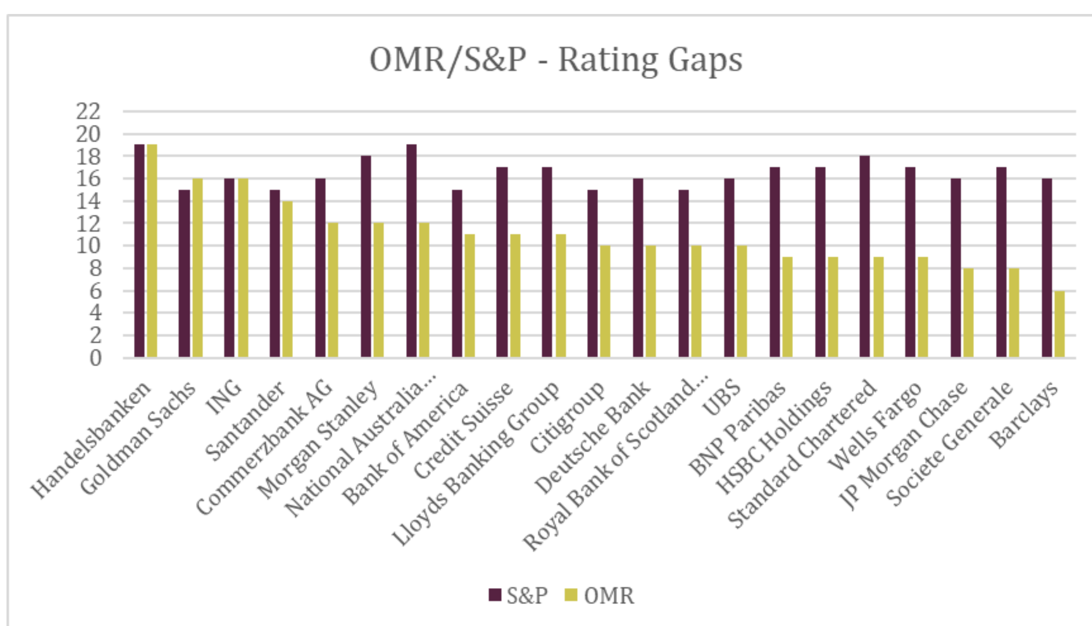

Figure 4. Low OMRs indicate significant long-term credit rating risk

Human Governance

8. Only in 3 banks (Handelsbanken, ING, Goldman Sachs) have we been able to discern the emergence of something approaching a whole system; which understands, reconciles and embeds human governance so that its human capital becomes a source of superior financial performance and long-term, sustainable value.

Human capital utilization

9. Our evidence shows that people can only realise their full potential in a highly mature organization, where systems are designed and built to encourage, enable and empower all human capital to release its maximum value. As the evidence becomes increasingly plain that human capital matters, issues such as diversity will begin to be resolved effectively for higher value outcomes.

10. It is clear that conventional approaches to talent (i.e. 'attract and retain') do little more than ensure target headcount. Beyond this, strategic efforts towards leveraging the full value of human capital are thin and not evident in most strategic plans. We note that annual reports rarely contain details of any strategic thinking around human capital management.

Innovation and improvement

11. Higher-rated banks are more likely to see ongoing innovations and improvements from human capital. Here, the search for extra value from continuous improvements becomes 'hard-wired' into company culture, including that of suppliers. Such innovation cultures become obsessive about incremental value in everything they do.

Corporate reporting and authenticity

12. Bank reporting, in keeping with a wider trend in corporate reporting where quantity trumps quality, and the limited insights they offer, are simply no longer fit for purpose. It is often intentionally opaque and a deliberate exercise in obfuscation.

13. Authenticity is critical to trust, engagement and cooperation. Many banks are failing to adhere to stated values or standards (e.g. codes of conduct) causing cynicism and significant value and risk implications.

Corporate Purpose

14. Nine banks articulated a purpose, that could be considered to contain a reasonable amount of societal responsibility, which informed strategic decision making. While this is encouraging it is neither as clear nor as convincing as it should be if the banks are to realize that having a societal purpose is the best option for underpinning long-term shareholder value.

15. Only three banks present evidence of the minimum level required to demonstrate that their societal purpose was sufficiently embedded across their operations: Handelsbanken, ING and Banco Santander.

Whole system management

16. The banks in this project remain largely fragmented organizations, with some regard for creating common and coherent, global control systems. However, without a mature capability for recognizing and dealing with the complexities of whole system management the risk management and value effects are bound to be limited.

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17. Banco Santander is one bank that has both recognized this need in G&C terms and is making attempts to create appropriate systems. It is notable that organizations like Handelsbanken and Goldman Sachs, who have relied less on growth by acquisition, are better able to operate on a whole system basis because of their organic growth strategy: thereby leveraging significant competitive advantage and value that should only continue to increase over time.

Executive reward

18. Executive pay systems are as broken in banking as they have become in the wider corporate world. They are rarely founded on any sensible principles which are applied consistently. As such, they are generally disconnected from long term, sustainable value and have lost all legitimacy in the eyes of societal stakeholders. However, Handelsbanken (who provide base salaries only) and ING offer an object lesson in how a more conventional pay structure can fit perfectly with the MI remuneration standard linked to TSV.

Trust and cooperation

19. It is evident from higher-rated banks that significant investment has been made to build internal management systems that facilitate autonomy to local decision makers who are closer to client or customer service. This requires very high levels of internal trust and serves to show how empowerment drives high value outcomes e.g. increased revenue generation and lower operational cost.

20. It is notable that banks such as National Australia Bank now require the taking of a banking oath for its senior executives[iii] and that the Dutch regulatory authority[iv] has enshrined an oath into law for bank such as ING. Such developments are extremely welcome given the evidence of low trust arising between banks and their external stakeholders.

SECTION 1. Questions and challenges

"Three issues that are critical to improving culture within the financial services industry:
1. Defining and clarifying purpose, because clear goals are necessary if one is to assess performance;
2. Measurement of how firms and the industry are performing; and
3. Whether incentives encourage behaviors consistent with the goals one wishes to achieve."
William C. Dudley President & CEO, Federal Reserve Bank of New York, London March, 2017

Setting global standards

The Maturity Institute's perspective is that the creation of a global banking system demands that all of the players are playing the same game; according to an agreed set of rules and common standards. The global banking sector does not currently satisfy any of these conditions systemically and therefore cannot be said to constitute a valid and socially legitimate global banking system.

The historical and current problems of the banking sector, and therefore the global financial system, can be traced back to a failure to establish these fundaments. This report addresses these issues directly and offers the prospect of a long-term journey for the banks, governments, regulators and other stakeholders around the world; to acknowledge and adopt these basic tenets in order to build a banking sector that we can trust more readily and rely upon for the future.

OMINDEX: deeper analysis and better investment decisions

Initial interest in OMINDEX originally emanated from the ESG (environmental, social, governance) investment community because it focused on human capital and was designed to measure the societal value of organizations. We welcomed this interest and are very grateful for the support of the ESG community. However, in line with the focus of the ESG community today, the OM30© instrument was always designed to provide mainstream investors with new insights and a greater predictive capability for forecasting the likelihood of sustainable, long-term value, while reducing exposure to material risk.

Maturity analysis, and the resultant OMRs, are increasingly regarded as clinical instruments for improved financial analysis and investment decision making. They enable investors to see organizations through a

new lens and to make a causal connection between supposed 'intangibles' and quantifiable, value added from measurable improvements in Outputs, Costs, Revenue and Quality (OCRQ).

OMR also incorporates a risk factor measure, as the obverse of the value 'coin', so OMINDEX can offer inter-company comparisons of both risk and value, simultaneously. The risk dimension has, in itself, been the subject of interest from regulatory bodies, who currently are unable to adequately codify G&C into bank related assessment, monitoring and control systems.

What is good corporate governance?

Good corporate governance is an open acknowledgement that the organization has a responsibility to humanity: that any organization is just one part of a global system and has to play its part accordingly. It is recognising that it has responsibilities outside and above its immediate financial and operational needs. Good corporate governance can only start from a good purpose and that purpose has to be offering society the best possible value without wasting any of the world's resources or inflicting any undue harm.

The essential 'goodness' of this purpose stems from the fact that using the world's resources to best effect is also, intrinsically, a moral purpose. So, legitimate corporate governance cannot be founded on serving the needs of a particular, vested interest (shareholders or executives); nor can it be sound if it is plundering the world's resources without any care or concern for the future.

Which banks have a CEO as Chair?
Bank of America
Barclays
BNP Paribas
Citigroup
Commerzbank AG
Credit Suisse
Deutsche Bank
Goldman Sachs
Handelsbanken
HSBC Holdings
ING
JP Morgan Chase
Lloyds Banking Group ORD
Morgan Stanley
National Australia Banking Gp
Royal Bank of Scotland Gp
Santander
Societe Generale
Standard Chartered
UBS
Wells Fargo (formerly)

Table 3. Joint Chair/CEO postholders appears to be an American phenomenon

Effective governance requires an effective organization at the top and this starts from a separation of roles between Chair and CEO. Allowing one person to simultaneously hold both posts is simply wrong in principle and pernicious in practice. Yet this situation exists in several US banks on this project today (see Table 3.).

In theory, such banks might be lucky enough to find a Chair/CEO who possesses a perfect combination of capability and integrity but a banking system has to be based on the highest probabilities, not luck. As a case in point, John Stumpf, formerly Chair/CEO of Wells Fargo, was deemed a

suitable candidate to hold both posts until the disastrous customer account scandal[v] under his tenure surfaced. In the event, he has now been replaced by a separate Chair and CEO. For the same reason, Jamie Dimon, with his 'fortress' mentality, should be viewed as both a present risk to JP Morgan Chase and a long-term risk in terms of all the implications his style of 'leadership' holds for succession planning.

Good governance requires board members and executives with specific and exceptional human governance expertise; an understanding of how all people connected to their organization are sources of value, and if managed badly, can become sources of significant risk. Boards and executive teams must have integrity with highly capable, independently minded, people working in harmony (not acquiescence) and setting a good example to all of the stakeholders in that organization – society at large. They cannot fulfil these roles to the best of their abilities and inclinations unless their organization has the necessary systems in place to help them achieve this, such as the right kind of executive reward. They also need to be able to pass the test of maturity themselves.

Based on this description we are not confident that good governance is the norm in banking and the crucial element, human governance, is missing. The Banking and Finance Oath[vi] in Australia and the Dutch regulatory oath are two developments that we believe are welcome and which bode well.

What is a healthy culture?

A healthy culture is dependent on a healthy governance structure. Culture is best summed up as 'the way we do things around here'. If the 'way we do things' is only to comply rather than enter into the spirit of good governance then misbehaviour will ensue. A healthy culture is one where people are encouraged to speak up if they believe they are witnessing the 'wrong way to do things'.

A healthy culture is one of never-ending improvement, learning and innovation. A healthy culture is one of evidence-based collegiality and fully informed, well-considered, consensus decision making: it cannot be dictatorial. Organizations create healthy cultures when they aim to make the most of the physical and intellectual capabilities of all of their people. This requires an environment where talent, capability and effort are not impeded in any way by divisional, functional or territorial rivalries or turf wars.

Healthy cultures do not have whistle-blowers because people are encouraged to speak up, within a well-ordered feedback communication system. Healthy cultures do not need whistleblowers because everyone is

behind the organization's purpose and trusts their leadership to make the right long-term decisions, coherently and consistently. They will have a systematic, positive and constructive process in place that welcomes ideas and innovations whilst encouraging an ongoing, never-ending critique of the organization and its operating methods.

The banking sector; with its high stakes, high risks and high rewards, reached its nadir in 2008 partly as a consequence of equivocal legislation and lax regulation but, more importantly, no one was measuring culture effectively. That capability gap is now resolved with the advent of OMINDEX which removes any remaining excuses for not taking decisive action against wrongdoing.

Is Corporate Social Responsibility (CSR) important?

The Maturity Institute takes a simple and focused view of corporate responsibility; companies must deliver as much value as possible with the resources at their disposal, without causing undue external (e.g. environmental) harm. This perspective puts social responsibility at the very heart of banking products and services and every other consideration is subordinated to this single goal. As a result, it removes much confusion around the topic of CSR, which has been predominantly viewed and managed as a peripheral activity in relation to core business operations and, on occasions, offered up as penance for unabashed capitalism.

In rating the banks, we attach no weight to CSR initiatives that are not directly linked to value creation. For example, 'community programmes', 'volunteer' and similar schemes that are disconnected from core business activities warrant no special mention. This does not mean that they should be discontinued, nor that they do not provide some value to society, simply that they do not factor as a positive indicator for OMR purposes. In the MI paradigm, social responsibility is mutually inclusive with shareholder responsibility; each one legitimising the other.

We contrast such schemes with CSR initiatives that do link to value, such as Goldman Sachs' "10,000 Small Businesses" programme[1] that provides Goldman expertise at no cost, to help both a critical business sector, and sow seeds of future value to Goldman itself. As such, the terms 'good' and 'responsible' within the realm of OMINDEX, are defined within a whole system philosophy of Total Stakeholder Value (TSV) maximisation, as described below.

[1] http://www.goldmansachs.com/citizenship/10000-small-businesses/UK/index.html?cid=PS_01_03_07_00_01_16_02&mkwid=UBG5tqwU

What about banking legality, regulation and societal legitimacy?

> *"We should hold off further rulemaking, digest what is in place and focus on what is needed for economic growth. These are commonsense steps... If these changes were enacted, US banks would continue to be among the safest in the world and would have the capital to help businesses, institutions and individuals pursue their financial goals and grow jobs. Isn't that what we all want?"* **James Gorman, Chair and CEO Morgan Stanley, Financial Times 14 June 2017**

We welcome these observations from James Gorman precisely at the time of finalising the writing of this report. The GFC, above everything else, should have helped us to restore commonsense. Once banking behaviour becomes a legal debate, rather than a cultural and societal imperative, the battle to regain commonsense is lost. Mature thinking is fundamentally a commonsense philosophy. Toyota never used technology where a pencil would suffice. Highly rated Goldman Sachs are rightly concerned about the cost of smartphones[vii] because they have a mature view that everything that adds or reduces value should be managed well.

Good management is legitimate management. While banking has become the focus for much of the debate around the malaise in corporate governance, such misdeeds have become endemic across the whole corporate world. Mis-selling drugs in the pharmaceutical sector (e.g. GSK et al), vehicle emissions in automotive (VW), slavery in supply chains (Nestlé) and the abuse of monopoly in technology (Microsoft et al) are so common place that they have been viewed as the price that we have to pay for pure capitalism. They should be viewed as symptomatic of a capitalist system that has lost legitimacy. While they are used as a strong argument by critics for better regulation and legislation, legality can never confer legitimacy on its own.

It was, of course, the GFC of 2008 that provided the sharpest lesson to catalyse thinking about the direction in which global capitalism has been heading since the latter half of the 20th Century, and in particular, the roles that banks should play and how they should be regulated. It continues to be a highly-charged topic today.

Certainly, the freedom which banks were allowed after many years of tight regulation and control, has contributed to the types of culture and poor governance that resulted in the misbehaviour that led to the GFC and to the many banking misconduct episodes since. This has prompted a series of reactions from authorities with misconduct fines being the most obvious. Many of the fines have been 'settled' without admission of guilt.

Whether this is because no one wants lengthy legal battles (and the pursuant costs), or is just a pragmatic response from regulators with limited resources; it is apparent that a long-term, systematic solution has not been in place thus far.

In reality, misconduct fines have been treated as a 'cost of doing business' – "as one analyst suggested the muted 2 per cent fall in Barclays share price showed a "misconduct discount" was permanently built in"[viii]. As a consequence, no one is dealing adequately with the root causes of the problem. So, we identify here the two main roots that are currently undermining both the banks and the wider corporate world:

1. Profit is a poor proxy for Total Stakeholder Value (TSV) – i.e. profit serves a narrow set of stakeholders and is now accepted as not delivering mutually inclusive value to society as a whole, therefore it has no intrinsic, societal legitimacy

2. There is no unequivocal or enforced legal requirement on corporations, to serve society rather than any other vested interest (notably shareholders)

Our simple solution addresses both of these core issues:

1. Measure the TSV of corporations and hold them to account for the never-ending pursuit of improving TSV (and report progress through OMINDEX).

2. Enshrine this simple, societal outcome as a requirement in corporate law and subsequent banking regulations.

Regardless of whether any regulatory or governmental actions will result from the publication of this report, we have already adopted and utilised TSV and now measure corporate governance and culture through OMINDEX, to determine performance against this standard. As this approach has already received widespread recognition, we encourage all stakeholders to consider how this can be utilised within their own context.

Until TSV becomes an underlying objective, James Gorman's recent call for a halt to more regulation is likely to fall on deaf ears, given the current state of banking G&C. Such a request is only likely to gain acceptance if and when the bank's themselves start acting in a manner that is perceived to be making a positive and measurable contribution to society as a whole. If we can trust the banks to keep focusing on generating value for all societal stakeholders, the need for regulation will recede and the banking sector will gain the societal legitimacy that it sorely needs.

Societal purpose or shareholder value?

"The shareholder-value movement did some good, especially in those early years. It became de rigueur for boards to create performance criteria that executives had to meet to get bonuses and stock options. And it was a means of imposing discipline…But the pendulum has swung too far, and today the ethos embodied by the phrase "maximizing shareholder value" does more harm than good. It has widened income inequality. It has rewarded short-term "make-the-quarter" thinking over long-term value creation. It is the reason companies take on too much debt and perform feats of useless — but stock-price enhancing — financial engineering. ….. When shareholders matter more than employees or customers or communities, some people do very well, but the purpose of a corporation becomes warped and society loses." **Joe Nocera, "Toppling the idol of shareholder value", Bloomberg, 4 May 2017**

As we have now outlined, two fundamental leadership lessons arose from the global financial crisis of 2008. First, corporations can no longer be left to define 'success' for themselves. Second, shareholders cannot be the arbiters of value because the era of shareholder primacy has finally run its course. Its replacement was meant to be corporate social responsibility (CSR) and that has morphed into ESG but both miss the essential point that any concept of responsibility has to be framed within the whole system. It cannot be translated into a disconnected series of discrete and separate activities such as employee engagement, community programmes or diversity targets. CSR has to contribute to shareholder value and societal value simultaneously and coherently, otherwise the system remains fragmented and is always liable to fracture.

The Maturity Institute sees the debate around shareholder primacy as a red herring because it views organizations in terms of their *total value* from their *total resource usage* across their *entire lifespan*. From this clear and unequivocal perspective, any notions of a distinction between 'short term' and 'long term' become meaningless. The finances and technology that enabled Shell[ix] to open up the North Sea oil industry, for example, always had to factor environmental considerations and eventual de-commissioning costs into its *total value proposition*. In matters of total stakeholder value, common sense tells us that what goes around comes around.

When Royal Bank of Scotland collapsed[x] into the arms of UK taxpayers in 2008 it was relatively easy to trace its demise back to low value (and 'groupthink') decision making, rather than crude cost 'shredding'. For example, reducing IT spend made immediate profits look better but the ultimate value was negative[xi]. More important still, RBS's OMR of BB- indicates a leadership team that is still below the threshold of maturity and therefore failing to learn properly from their own previous mistakes.

Perhaps what we are witnessing here is the struggle of society having to decide whether and how it should develop, encourage or impose a societal conscience on its banks? One lesson that had to be learned by many industries in the latter part of the 20th Century, when introducing Total Quality Management, was recognizing that they were starting from a position of 'unconscious incompetence'[xii].

Any bank leadership team that wants to be seen as socially responsible needs to go through that same learning process and accept that they have to become *consciously competent* about how to make social and shareholder responsibilities work in harmony, not opposition. Any notion they might hold that they are being socially responsible by maximizing shareholder value is a myth[xiii]. It completely misses the obvious and commonsense point that they cannot possibly achieve that goal without consciously maximizing the value of all of their human capital. So, the only way forward is to make both shareholder value and societal value one and the same – this approach is encapsulated in OMINDEX and we call it Total Stakeholder Value (TSV) because it captures the totality of value in the long term.

Total Stakeholder Value (TSV)

Total Stakeholder Value (TSV) is a measure of mutually inclusive long-term value that reconciles both the generation of returns for shareholders and value created for all societal stakeholders. It combines a conventional indicator of organizational performance – the P/B or price to book ratio – with a corporation's organizational maturity rating (OMR) score in the OMINDEX. The most mature organizations, reflected in a high TSV, are able to both generate the very best financial performance while at the same time maximizing their contribution to society.

MI's TSV Standard combines the P/B (price to book) ratio with a corporation's maturity rating score in the OMINDEX as follows:

TSV = P/B x OMR

For example, Barclays Bank's P/B is 0.49[2]. The P/B ratio, on its own, reveals the value that the stock market attaches to Barclays, through its share price, relative to its asset value. In layman's terms, a P/B of less than 1 implies the bank is not being managed well enough to at least deliver the returns one might expect from its asset value. However, as with any indicator, we should not view it in isolation. Even if Barclays had a P/B of, say, 1.5, it might suggest it is being well managed but it has not taken into

[2] As at May 2017

account another significant variable – its human capital and how that capital is governed and managed on a day-to-day basis. In other words, P/B only captures part of the overall, value equation. When Barclays OMR of CCC+ (23.9%) is factored into the equation it produces a TSV of 0.12.

What the market cannot deny is the clear evidence that banks with higher OMINDEX ratings outperform those with lower ratings across critical indicators, *including conventional financial value metrics*. This makes it as much of an issue for investors as the banks themselves.

Rather than being diverted here by the specious question of bank *size*, therefore, our focus in this report is on the continuing likelihood of bank *failure* combined with the banking sector's current inability (including its legislators and regulators) to determine what indicators denote responsible *human governance and healthy corporate culture* and what measures can be used to demonstrate the value (and lower risk) of G&C that can serve society's best interests.

Some important roots of the banking and finance crisis of 2008 can be traced back to the dominance of the largest US banks (who now make up 30% of the original CCP misconduct costs league table[3], with 4 in the 'top' 5 positions). Moreover, importation of US bank practices helped to cause this to become a sector-wide problem. For example, UBS made notable and wholesale transfers of key staff from the US, while other European banks made many significant acquisitions of US based banks. Despite China now emerging as major global banking force, US banking hegemony in Europe continues in other forms too, such as with former JP Morgan bankers now at the helm of Barclays and Standard Chartered.

The dominance of US practice is proving particularly resistant to any regulatory approach or market therapy (viz the Wells Fargo scandal of 2016) because the prevailing sentiment is still one of shareholder primacy and profitability rather than sustainable value. Introducing OMR analysis and rating into this debate offers a new lens and can train a spotlight on those banks where management capability is lacking in relation to the complexity and size of the banks presenting the greatest risk.

The Risk – Ratings Gap

It is highly significant that conventional (e.g. S&P) credit rating is still rating most banks as creditworthy despite the continued incidences of material misconduct causing potentially fatal damage. Only last year, Deutsche Bank (S&P A-, OMINDEX BB-) was rumoured to be in need of a

[3] http://conductcosts.ccpresearchfoundation.com/conduct-costs-results

German government rescue[4] subsequent to notice made of a forthcoming US misconduct fine. Wells Fargo was rated A+ (S&P) before its recent sales scandal and remains at A[5].

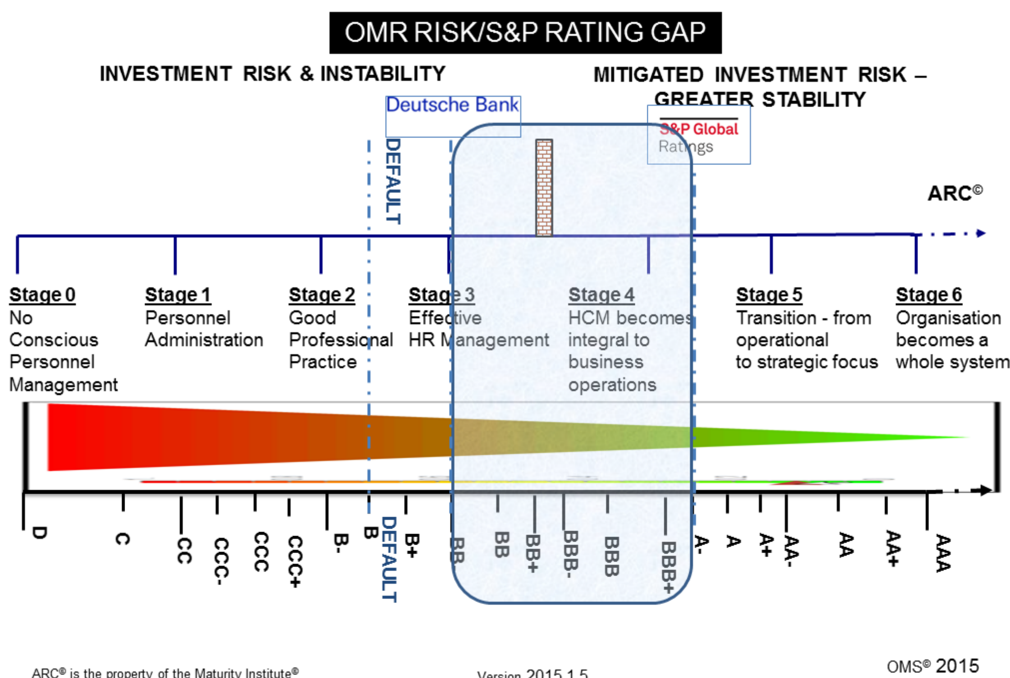

Figure 5. The average gap between S&P and OMR on the "AAA" scale

The chart in Figure 4, earlier, indicated an important disparity in the gap between banks with the lowest OMR scores and their long-term, positive S&P credit rating.

OMR was designed specifically alongside conventional credit rating to make up for the limitations of its backward looking financial analysis. OMR presents a current and comparative perspective of G&C and its methodology facilitates a forward-looking lens that can be used as a leading indicator of potential future value. In this way, OMNIDEX is a predictive index that points to a likely decline in the fortunes of companies with low OMRs. Investors should take note that while some improvements in G&C can be made quickly (e.g. separation of Chair/CEO roles) turning around poor G&C from a low base is a lengthy and arduous task; the early warning signs of OMR should therefore be heeded.

[4] http://www.telegraph.co.uk/business/2016/09/26/the-deutsche-bank-crisis-could-take-angela-merkel-down--and-the/
[5] https://www.wellsfargo.com/about/investor-relations/debt-rating/

SECTION 2. Critical observations from OM30© questions

The analysis of the research prompted by the questions that make up the OM30© (see Appendix 1) can be viewed from three particular angles to produce evidence and insights from which we can draw tentative conclusions. Obviously, the more an organization actively engages in this process the more valid the conclusions. The three angles are:

1. Clusters of questions that form a particular perspective and produce a combined percentage score, shown on a traffic light scale
2. Specific evidence collected in relation to specific questions
3. Adopting a perspective focused exclusively on risk

Below we explore each of these angles in more detail.

1. Question clusters

Human Governance

"Our business model and our way of working are based on a fundamentally humanistic approach…When every person feels involved and takes responsibility, then they make more of those smart decisions, resulting in lower costs, more satisfied customers and higher profitability." **Anders Bouvin, CEO Handelsbanken 2016 Annual Report**

MI defines *Human Governance* as the management of material value and risk with respect to an organization's entire human capital, comprising all people connected to it e.g. workforce, suppliers, customers, and relevant societal stakeholders. Anders Bouvin's quote above encapsulates Handelsbanken's whole system approach; which understands, reconciles and embeds human governance across the bank on the basis that its entire connected human capital is a source of long-term, sustainable value that translates into the very best financial performance.

Within the OM30 instrument we measure the extent to which human governance is integrated into whole system operations. This cluster comprises questions 5,6,7,8 & 26 on OM30 to produce a picture of human governance levels. It incorporates measures of organizational trust, values, principles and cooperation.

It should be noted that we could find no cases where the term 'human governance' currently features in any of the annual reports or other, publicly available, banking information: this is a significant finding in itself. Within the banking sector and across the wider corporate world,

there is a paucity of understanding of the nature and importance of human systems as they create both value and risk.

Our evidence confirms that an absence of human governance is not just a matter of language but signifies both a lack of understanding and capability. The figures in Table 4 suggest significant room for improvement in this area.

B&GCP Traffic Lights (%)	Human governance - Indicator 3
Handelsbanken	91
ING	68
Santander	68
Goldman Sachs	65
Commerzbank AG	64
National Australia Banking Group	62
Standard Chartered	62
Bank of America	58
Morgan Stanley	55
HSBC Holdings	51
Lloyds Banking Group ORD	49
Royal Bank of Scotland Group	48
UBS	47
Wells Fargo	46
BNP Paribas	45
Credit Suisse	45
Deutsche Bank	42
Citigroup	40
Societe Generale	40
Barclays	36
JP Morgan Chase	31

Table 4. Human Governance

The lower scores tend to reflect banks that view their people primarily as an overhead, or other cost, without any consideration for the value potential they may have. It also suggests that the other critical human capital stakeholders, such as customers, are not given the strategic priority that many banks purport to do. Only Handelsbanken is able to demonstrate just how much its view of human capital is entwined with its business philosophy and relationship strategy.

Human Capital Utilization

> *"They [women] are able to flourish because they are given the system to work within."* **Kate Richdale, Co-head Investment Banking, Asia, Goldman Sachs (FT 13 April 2017)**

Much time and attention is devoted to issues of talent attraction and retention, and particularly diversity. Our evidence supports our view that people can only realise their full potential in a highly mature organizational context and environment, where the systems are explicitly designed and built on the basis that all human capital is a source of value to be maximised. Once this is achieved long standing structural issues such as diversity will get resolved.

Our evidence demonstrates that conventional approaches to talent (i.e. a primary focus on the attraction and retention of staff) do little more than ensure that banks have requisite headcount levels. Beyond this, strategic

initiatives and management practices that can leverage value are thin and are rarely connected to value outcomes in terms of OCRQ and return on investment.

The Human Capital Utilisation cluster is comprised of OM30 questions 12, 13, 14, 15, 17, 24, 25 & 28 and takes a more operational view of how human capital is managed. It incorporates measures of integration with the organization's strategy, culture, systems and business planning. It also checks to see if any overt attempt is being made to directly connect people management with value and the bank's reward system (although 'reward process' is a more accurate description).

Banks with low OMRs are prone to report on items such as 'diversity targets' without any explanation of how these targets are connected to higher levels of value or lower risk. Such targets are therefore disconnected from the organization's operations. Maturity analysis does not rate diversity as an end in itself.

B&GCP Traffic Lights (%)	Human capital utilisation - Indicator 4
Handelsbanken	81
Goldman Sachs	73
ING	70
Santander	51
Bank of America	43
Deutsche Bank	43
Royal Bank of Scotland Group	43
UBS	42
Lloyds Banking Group ORD	41
Morgan Stanley	41
Citigroup	40
National Australia Banking Group	40
Wells Fargo	38
Commerzbank AG	37
BNP Paribas	34
JP Morgan Chase	34
Standard Chartered	34
Credit Suisse	33
HSBC Holdings	33
Societe Generale	26
Barclays	14

Table 5. Human Capital Utilisation

Low rated banks also tend to have 'talent' processes (e.g. annual performance appraisal, international assignments etc) managed by conventional HR functions rather than an integral part of strategically designed talent systems.

In our analysis, Goldman Sachs provides evidence of the most sophisticated talent systems within the sector. Kate Richdale's insight supports our own view that the only credible approach that can work to solve this issue is to build *management systems* that support the development of all available talent to realise all human potential that touches the organisation - regardless of gender, race, religion etc. One of the most important aspects for a company is to understand how to become a true 'learning' organisation such that everyone is able to contribute as fully as possible to value creation. In the MI paradigm, true diversity is the outcome of a high value organization born out of a societal

purpose and which has much more legitimacy than simplistic targets or quotas.[xiv]

Bank innovation: 'Improvement Engines'

Most banks analysed tend to view innovation through the lens of product and service development e.g. developing digitisation and fintech strategies. We found significant R&D investment being made in these areas by all banks. However, this considers only one facet of an organisation's capacity and ability to innovate and improve.

B&GCP Traffic Lights (%)	Improvement engine - Indicator 8
Handelsbanken	74
Goldman Sachs	70
ING	62
Santander	61
Morgan Stanley	56
Credit Suisse	54
Commerzbank AG	53
National Australia Banking Group	50
UBS	48
Bank of America	45
Citigroup	42
BNP Paribas	41
Wells Fargo	40
Deutsche Bank	39
JP Morgan Chase	38
Lloyds Banking Group ORD	38
HSBC Holdings	33
Standard Chartered	33
Royal Bank of Scotland Group	32
Barclays	28
Societe Generale	28

Table 6. Improvement Engines

Higher rated organisations are more likely to see and demand innovation and improvement from everyone. They 'hard-wire' improvement into all human capital, including suppliers. Such innovation cultures become obsessive about improvement and constantly strive to add incremental value in everything they do.

This cluster is comprised of OM30 questions 19,20,21,23,30 – covering the organization's philosophy on never-ending improvement; its approach to quality; employee innovation; the way the organization learns and its agility. Together, these facets measure an 'improvement engine' for value adding progress and an adaptability to change.

One specific indicator we look for under 'innovation' is a system for collecting employee ideas and turning them into tangible value. We use Toyota's measure of *one idea per employee per year* being regarded as a 100% innovation rate (ideas may of course come from non-employee human capital). Deutsche Bank was the only bank who had any measure that approximated to this but their rate was nevertheless comparatively low at 2.4% and did not constitute a *system.*

Of course, this chart should be set alongside the other charts above. How many ideas are employees likely to generate if they are regarded only as a cost? How many ideas will be generated if whistleblowers are actively

discouraged and the management are content to create an environment of fear? As with any human capital management initiative, success depends on the management maturity arising from the whole system.

2. Analysis of evidence against specific OM30© questions

"Modern annual reports are pretty useless documents. Prospectuses are not much better. Public companies publish vast quantities of this type of financial information, but most of it is not fit for the purpose of helping investors make better decisions. Unfortunately, statutory accounts have become increasingly complex and obscure – and therefore impenetrable, even to professionals. Investors, analysts and lenders rely on the financial statements of PLC's to understand their creditworthiness and performance. Yet I suspect fewer people than ever actually read these expensively prepared tomes.". **Luke Johnson, chairman of Risk Capital, in Sunday Times 28 May 2017 "True and fair? No, annual reports are as clear as mud"**

Authenticity

Authenticity is a measure that has become increasingly important. Simply put, to what extent can we take at face value what a bank tells us about itself? If we are unable to do so, to any great extent, then what does that tell us about how a bank's human capital are likely to view it? What kind of relationship or psychological contract do they have with their employer?

Question 1 of the OM30© includes a specific measure of leadership authenticity from 0 to 10 (highest authenticity) and the results are shown in Figure 6.

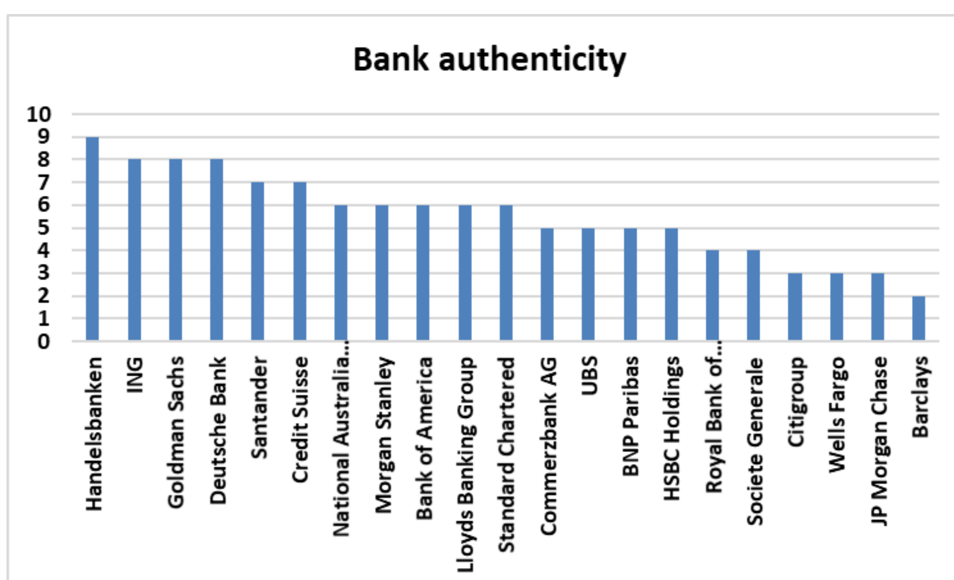

Figure 7. Banks in order of authenticity scores

Authenticity is much more tangible than you might imagine and less problematic to measure than you might expect. When a bank's annual report or website espouses values that are obviously counter to its observed behaviours, it is reasonable to deduce that it is either unaware of its own contradictions; is incompetent at maintaining a level of coherence in its reporting, or does not care too much either way. It is the weight of this type of evidence, across the whole of the OM30 data gathering and analytical process, that produces the overall score out of 10.

Handelsbanken scores very highly because its decisions are consistent with its philosophy and values: to the extent that it removed its last CEO for wanting to work on a different basis. At the opposite end of our authenticity scale Barclays' CEO Jes Staley stated in the 2016 Annual Report that:

"Barclays will be known for the way in which we do business, the integrity with which we operate, having a positive impact on society, and delivering shareholder value."

It is not too difficult to identify such inauthenticity when the same CEO is prepared to ignore his compliance team and bypass recognized corporate and regulatory practice in a determined effort to unmask an internal whistleblower[xv] and the same CEO has a simple 'strategy' (sic) of poaching[xvi] rather than building from within. This lack of authenticity undermines what Staley, and therefore Barclays, say in their public communications. Interestingly, Staley's former employer also has 'form' on the same subject. In late 2016, JP Morgan Chase was fined for firing a whistleblower.[6] This is why MI predicted that Staley would behave in this way long before such behaviour was manifest.[xvii]

These two episodes indicate much about the application of standards at Barclays and JP Morgan. Much more important though, in value and risk terms, is that both banks publicly sent clear signals to Barclays and JPM Chase employees (and all connected human capital: e.g. suppliers) that to speak up when you see misconduct may run serious professional risks. Such action undermines the company's risk management systems but also undermines *trust, engagement and cooperation;* key facets of value creation that no bank should be damaging.

Authenticity is crucial to effective banking governance and healthy culture and the behaviours of inauthentic banking leaders and senior staff are often highly visible. Inauthenticity is also a good predictive indicator of future, sub-optimal performance because large workforces spot the signs

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[6] https://www.dol.gov/newsroom/releases/osha/osha20160314-0

quickly and behave accordingly; withdrawing effort and potentially damaging the organization in a variety of ways.

Corporate Purpose

A clearly articulated purpose? *"We've operated for over 150 years in some of the world's fastest-growing markets, across Asia, Africa and the Middle East…We're a leading international banking group committed to building a sustainable business over the long-term…Everything we do is about being Here for good – in business, through life, and when it matters most for our clients."* **'About Us' Standard Chartered Bank, 2017**

It is increasingly well documented that purpose matters to value, but our work demands that it must be defined and measured against a common standard.

We constructed our OM30© instrument on the premise that human capital will generate more value, and mitigate risk, if they are aligned to a common purpose. Additionally, a purpose explicitly linked to societal value matters more. We know from growing evidence[xviii] that people prefer to work and add more value when purpose gives meaning to their working and personal lives.

Purpose and societal value are thereby synonymous. We define both as producing the *"Best quality product or service at best possible cost (including any external harm e.g. environmental impact)."*

This means that the very best banks will serve society first, that is their customers and the wider community, on the understanding that this produces the best returns for other stakeholders too. Only when all banks work to this standard will we have a banking system that makes the best possible contribution to society.

The OM30© instrument specifically measures 3 dimensions of purpose:

2a. Identifying if an organisation has a clearly articulated purpose and; if yes
2b. Whether a clearly articulated purpose affords societal value primacy in business decision-making; and if so

Which banks appear to have a societal purpose?
Bank of America
Barclays
BNP Paribas
Citigroup
Commerzbank AG
Credit Suisse
Deutsche Bank
Goldman Sachs
Handelsbanken
HSBC Holdings
ING
JP Morgan Chase
Lloyds Banking Group ORD
Morgan Stanley
National Australia Banking Gp
Royal Bank of Scotland Gp
Santander
Societe Generale
Standard Chartered
UBS
Wells Fargo

Table 7. Can banks without a societal purpose be responsible?

2c. The extent to which societal value primacy is embedded across operations.

Our conclusion, based on this standard, is that Standard Chartered Bank's statement does not amount to a meaningful or value-focused purpose. A purpose statement that is not clear can be misinterpreted and loses its power as both a motivating and focusing force. A bank will not survive long if it does not provide services that customers want but can more readily thrive if its ultimate purpose is to have a mission to provide the best possible quality at the best possible cost. The banks that achieve that will build competitive advantage that has the potential to put other banks out of business.

Table 7. identifies nine banks that articulated a clear purpose, societal in its dimension, and which informed primary decision making. This is encouraging and undoubtedly reflects the enormous pressure provided by regulators, governments, and wider societal stakeholders that business models that precipitated damaging misconduct costs are no longer fit for purpose.

However, what the table does not convey is the extent to which these articulated societal purposes were seen to be embedded operationally across businesses. In this respect, the picture is less encouraging, with only 3 banks managing to evidence the minimum level of success required: Handelsbanken, ING and Banco Santander.

Whole system management

> *"…to further strengthen the relations between the parent bank and its subsidiaries… The purpose here is to ensure the consistency and soundness of decision-making processes, control systems, information flows and control mechanisms on a Group scale."* **Banco Santander, 2017 Goals, Annual Report**

Several OM30 questions are specifically designed to establish whether well-defined and robust systems are in place. Effective systems are crucial not only to how a company operates and performs but how it complies to externally imposed standards. MI defines a system as providing the means to achieve a purpose – and we have already established the standard of an acceptable purpose above. The purpose should be made clear to everyone to drive value creation and risk minimisation but OM30 identifies the underlying 'human systems' that are necessary to support a healthy culture in the face of all other pressures. Questions 20, 21, 22 and 23 cover four specific, yet closely interwoven, human systems of:

- Quality
- Innovation
- Performance
- Learning

Our OM30 instrument is predicated on whole system thinking and management but most banks, despite already being default (i.e. not designed) whole systems, are yet to develop the capability for managing themselves accordingly. This is more a statement of fact than a criticism. Whole system management demands a greater level of sophistication than has ever been seen before, in holistic, economic, environmental and political thinking; along with effective leadership and management practice.

In our search for the incipient signs of such thinking, we look for evidence from banks that they understand this fact and are doing whatever they can to keep moving in the right direction. For example, low rated banks have started setting themselves targets on environmental and social issues but these are not generally integrated into their own whole management system.

Banco Santander's statement suggests a more mature perspective at work. It is this intent that gives us confidence that their whole system will continue to work better over time. We note that Handelsbanken takes enormous care to nurture and protect its own 'ecosystem', whereby branches are given significant autonomy and responsibility and the role of corporate headquarters is to provide support to this cohesive network. Goldman Sachs, despite many problems born of its own doing, continues to make every attempt to ensure that their human capital works cooperatively in a value system designed to work for the greater whole, and not just for individual parts.

The implications of this whole system perspective cannot be overstated. Even where the intent is clear and laudable, the tools and mechanisms to make the organization holistic are not (see Section 4.). The most obvious disconnect is between conventional accounting & financial reporting and a bank's TSV. A financial report can tell us how much electricity has been saved as part of an environmental target but it does not currently reveal whether the attitudes of the entire workforce are motivated enough to switch every single, unnecessary light off, at every possible opportunity.

Financial reports might tell us how much business revenue is being generated but not how it was generated or whether it can be generated in the same way in the future. Until banks adopt whole system, integrated reporting; that incorporates clear indicators of governance, culture and

employee attitudes, they will continue to present only a very limited and partial view of their full potential.

Trust and Cooperation

> *"Handelsbanken's constant aim is that all important business decisions should be taken as close to the customer as possible. This contributes to better meetings with customers, better decisions and more satisfied customers."*
> **Handelsbanken 2016 Annual Report**

The OM30 considers trust from a total stakeholder perspective (e.g. workers, suppliers, and customers) and primarily looks at evidence relating to the organisation itself and to senior leadership. Cooperation is primarily considered from an internal human capital perspective (workers and suppliers). Both concepts can be viewed separately but our methodology regards them as inextricably linked.

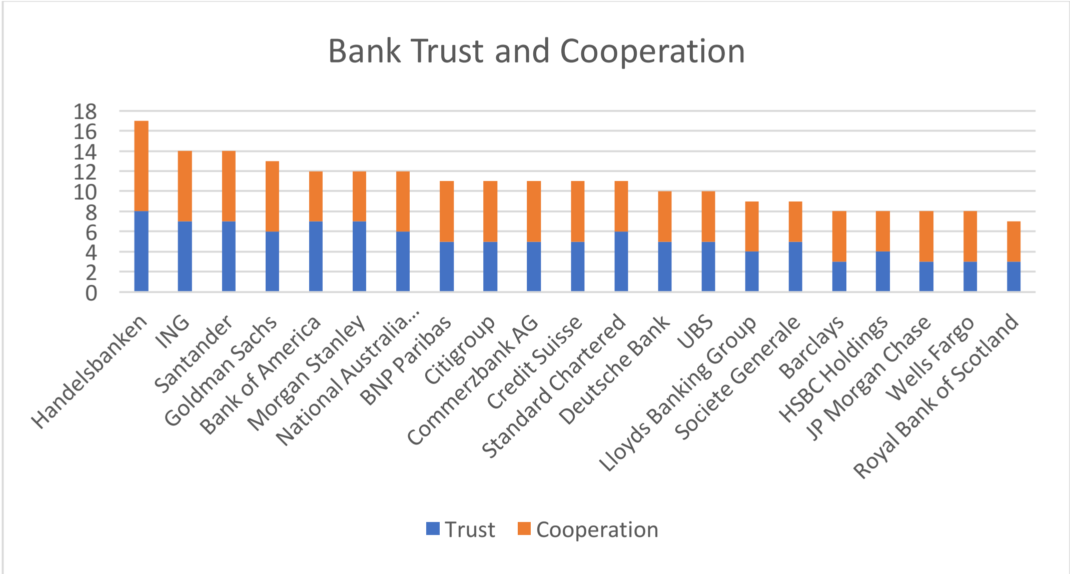

Figure 8. Bank trust and cooperation

Much has been documented about the lack of trust with banks themselves and evidence shows that organisations continue to struggle with fostering wider stakeholder trust[7]. This lack of trust is reflective of a similar lack of trust inside most of the banks we rated. Without this fundamental characteristic, the idea of nurturing cooperation to create value becomes a herculean task. Goldman Sachs has prided itself on achieving high levels of cooperation across its global business, yet undoubtedly saw this eroded in the years leading up to and after the GFC; when certain parts of the business caused lasting reputational and regulatory damage.

[7] http://www.ey.com/gl/en/industries/financial-services/banking---capital-markets/ey-global-consumer-banking-survey-2016

It should be noted that measures of internal trust were not publicised in the banks rated (and we assume not often measured) and although many banks were more willing to be open about customer metrics, these were often selectively provided to paint a better but less realistic perspective.

Autonomy matters: it is evident from higher rated banks that they have spent significant time and resources to build internal management systems that facilitate autonomy to local decision makers who are close to, or provide, direct client or customer services. This requires extremely high levels of internal trust but is an example of how such empowerment drives high value outcomes in terms of increased revenue generation and lower operational cost.

Board and C-suite capability in governance and culture

"A healthy corporate culture is a valuable asset, a source of competitive advantage and vital to the creation and protection of long-term value. It is the board's role to determine the purpose of the company and ensure that the company's values, strategy and business model are aligned to it. Directors should not wait for a crisis before they focus on company culture." **UK Financial Reporting Council, July 2016**

We agree wholeheartedly with the sentiments expressed by the UK FRC. However, like other global stakeholder bodies, the FRC does not have tools or instruments to offer boards or executives who may already know that healthy culture matters. In this respect, despite much discussion about governance and culture, there is little evidence of any capability to provide solutions to these complex problems.

Within the banking sector, there is little acknowledgement of this capability gap among the banks themselves. For example, while Wells Fargo's board's activity comprises typical committees, and does convene a committee on "Human Resources" (whose remit has now expanded to cover culture and risk), we only find evidence of conventional management practice deploying standard HR processes. We also note that the Board lays claim to significant "Human Capital" expertise, yet the biographies of all members show no professional qualifications or specific experience in this respect. Indeed, which august institution would be capable of providing such expertise?

In the absence of such capability we have seen a proliferation of board committees tasked with a range of subjects including governance, culture, responsibility and diversity. The existence of such committees could be viewed as a cynical exercise in 'playing to the gallery' but it is our view

that the truth is much more prosaic: these committees are primarily an attempt to ‘do something rather than nothing’, under pressure for action from regulatory stakeholders who have little to offer themselves.

So far, the banks who have organized board committees and responsibilities to oversee G&C improvement show little evidence that such initiatives have made substantive improvements in organizational health. Where no such efforts are being made, we have identified another common tactic – the *‘7-step response’*:

Bank scandal or failure: the 7-step response

Our analysis confirms that most corporations adopt what has become an almost ‘tick-box’ approach to governance and culture change subsequent to any corporate scandal or failure:

1. Issue a denial that failures reflect the bank’s purpose or core values
2. Identify and remove ‘responsible’ individuals (preferably low-ranking staff)
3. Carry out an internal ‘independent’ review of the failure
4. Establish or re-establish company “values”
5. Provide training in company values and ethics (especially for leadership)
6. Identify incentive payments as a key cause and change/amend
7. ‘Strengthen’ internal controls and compliance teams

For example, Standard Chartered’s ‘Brand, Values and Conduct’ committee is promising the use of cultural metrics at some point in the future and advises that:

"*Two informal discussions were held with external experts in brand and implementing cultural change. These provided the Committee with relevant best practice and lessons learnt from other large global organisations.*"

Note here the use of the term ‘experts’ and ‘best practice’ and consider what expertise and best practice should already be in place from the professional function that supposedly knows something about human resources. We have no particular recommendations for HR functions except to say that we regard them as ‘missing in action’. HR functions do not make organizations more mature and only administer those who are. In fact, our mounting evidence demonstrates that achieving high OMR scores will have to happen in spite of the drag of conventional HR practices.

Knowledge, learning and innovation

One specific area where executives have a right to expect expertise from their HR function is in training and development. Yet this is probably the most immature aspect of banking management. Even Goldman Sachs, with its high OMR, is guilty of a rare example of crass reporting when it comes to training provision; despite being best in many other respects of organizational learning.

"As part of our commitment to training many divisions ask that their people meet a minimum 10-hour annual continuing educational goal, and 20 hours is the ideal."[xix]

Why is this crass? Because if you read the full text from which this derives they have already shown that they have probably the best learning system of any company currently on OMINDEX. Setting a target for training hours, an *input*, which comes with no guarantee of value, undermines their own thinking and exemplar capabilities. Goldman Sachs actually do create the environment where up-to-date knowledge is readily available and there is a culture of continuous learning (linked to performance) that produces continuous innovations. As they stated on their last Form 10k:

"Another important part of instilling the Goldman Sachs culture is our employee review process. Employees are reviewed by supervisors, co-workers and employees they supervise in a 360-degree review process that is integral to our team approach, and includes an evaluation of an employee's performance with respect to risk management, compliance and diversity."

So, it is our more positive view that their subsequent claim is actually justified and they still warrant their high OMR:

"At Goldman Sachs, we recognize that learning is a competitive advantage, and we are committed to helping our people reach the peak of their capabilities."

The other banks on this project are so poor in this respect that they are unlikely to recognise the differences between training being an 'input', learning being an 'output' and value being the only outcome worth having. They also employ 'training professionals' who see nothing wrong with reporting how many hours someone sits in a classroom or in front of a screen[xx]. Of all the metrics that companies routinely collect 'training hours' is the most vacuous (it measures time not training) and although this might seem a case of semantics it is actually a very clear contraindicator of a bank's capability for organizational learning.

As we have already indicated above, innovation is consistently expressed as projects, programmes or initiatives to drive product and service development e.g. digitalisation and investment in FinTech. It is rarely considered as a responsibility of all human capital and applied in the context of the entire business operation.

Consequently, there is a huge banking sector capability and opportunity gap here. The most mature organisations see knowledge, learning and innovation as an inseparable whole.

Executive remuneration and reward

Given the amount of interest, commentary and analysis on the subject of executive pay, there is little surprise that CEO and executive pay within the banking sector fits with the prevailing patterns observed within the wider corporate world.

Our analysis has found lengthy remuneration reports that serve to confuse rather than clarify. We have found weak, and in some cases, non-existent principles that fail to link pay to long-term value. We also witness a predominance of pay driven by "market competitiveness" that has created a vicious upward ratchet effect in pay magnitude. There is also myriad of complicated plans with a scarcely concealed intention to obfuscate. When lengthy and confusing narrative is stripped away, what is left is primarily geared to incentivize financial return to the detriment of broader value drivers (such as product or service quality).

Most bank CEOs and executive remuneration systems remain primarily driven by short term financial targets (e.g. 3-year vesting "Long Term" incentive plans) and are not adequately aligned to key value and risk drivers as defined by MI's global standard of Total Stakeholder Value (TSV). Only 3 banks manage to produce a credible link between CEO pay and TSV as per the chart in Figure 9 below.

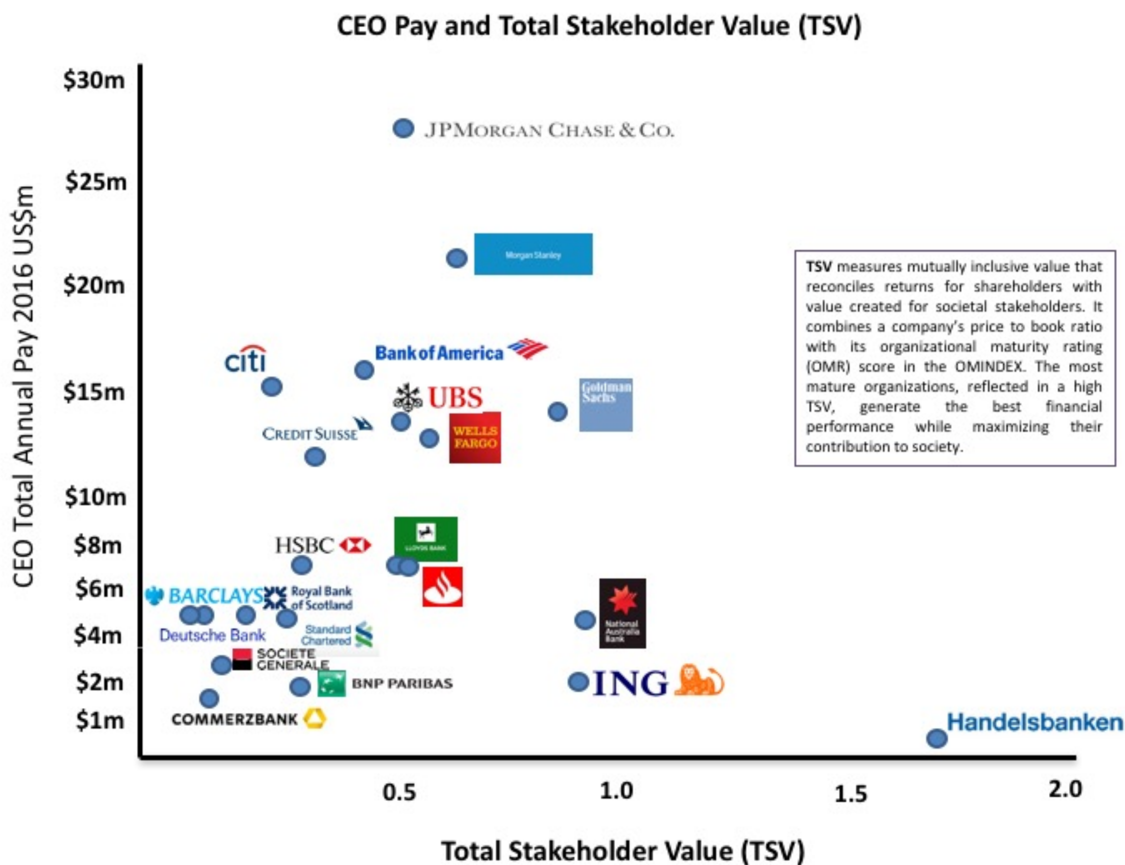

Figure 9. CEO remuneration and TSV

MI's approach to this problem has been to define a global standard for executive remuneration[xxi] and performance[xxii]. This combination of standards is a lesson for regulators. It provides for an executive remuneration system that is explicitly linked to Total Stakeholder Value (TSV); our value measure that combines a company's shareholder returns with value created for all relevant societal stakeholders. In a practical context, our TSV pay standard analyses the extent to which CEO and executive pay incorporates the following characteristics:

- Remuneration and assessment systems linked to a clear corporate purpose and value statement
- Pay principles set according to a broader understanding of value creation serving the best interests of society as well as shareholders i.e. Total Stakeholder Value (TSV)
- Pay levels that can be, or are, set at lower, overall levels than direct peer group comparators
- Variable pay (incentive bonuses) used to drive actions and behaviours linked to TSV that balance our core value drivers of output, cost, revenue and quality.
- Any equity awards are long-term focused and geared to generating (in practice) higher equity value beyond a 10-year time horizon

Our chart in Figure 9. focuses specifically on CEO pay as representative of each banks' executive pay regime. In summary, it shows that in the global banking sector, high pay for CEOs is no guarantee that society will be served well by our banks. But nor does it mean that shareholders will either.

Handelsbanken achieve the highest level of TSV, meaning that shareholders are seeing high value in terms of market value, while the company drives value with, and for all, its stakeholders. In practice, this has seen the bank achieve both the highest levels of profitability and customer satisfaction in its sector, for over 40 years. All this is done with an extremely modest level of executive pay that most boards undoubtedly choose to ignore or perhaps claim is due to specific 'cultural' factors that cannot be replicated.

By comparison, JP Morgan shareholders may be getting 'good' investor returns by conventional (immature) standards but this is sub-optimal when referenced against mature peers. Moreover, customers of JP Morgan remain poorly served and serious quality and misconduct issues continue to arise on a regular basis[8].

Our graphic also provides further evidence that executive pay systems remain broken and disconnected to the levels of long term, sustainable value that is being increasingly demanded by societal stakeholders. In addition to Handelsbanken (who provide base salaries only) we have also highlighted ING below as an object lesson in how a more conventional pay structure can be put in place to fit the MI standard. ING deliberately pay:

- below the mid-point for its comparator CEO's
- limit annual bonuses to 20% of salary (a local regulatory requirement); which
- are linked to non-financial performance for more than 50% of the award; and
- pay any bonus in shares only, that must be retained for more than 5-years

ING achieve broad value (TSV) outcomes and seem to readily attract and retain talent to manage this large bank (i.e. c. EUR60bn market cap organisation).

[8] http://violationtracker.goodjobsfirst.org/parent/jpmorgan-chase

Linking executive pay to long term value, ING's policy advises:

"The Executive Board remuneration policy aims to award total direct compensation **slightly below** the median of comparable positions in the chosen peer group…variable remuneration for the members of the Executive Board is limited to a **maximum of 20%** of base salary at the time of award. It is based for at least 50% on non- financial performance criteria and fully **paid out in shares**…A **retention period of five years** from the date of grant applies to all share awards granted to Executive Board members in their capacity as Board member.

SECTION 3. Risk management

> *"In recent years, the incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets."* **Mark Carney, G20 Letter, 30 August 2016**

When we asked a small sample of CFOs to define 'added value', the response was generally very narrowly focused on value as a purely monetary unit; where added value is measured simplistically as 'revenue minus cost.' Throughout this report, it has been easy to demonstrate that this 'formula' is now so limited in scope that it is no longer fit for any purpose.

One of the main reasons for its obsolescence is that it does not take into account the other side of the value 'coin', which is risk. These are two, indivisible, yet entirely different concepts requiring different measurement strategies. Only with a profound and mature understanding of their inter-relationship can whole system management become a reality. Banks create value but with every value opportunity (won or lost) comes risk.

Just before the crash of 2008, when S&P and other credit rating agencies, were awarding RBS a 'AAA', the CFO of RBS was reporting excellent profits. Yet the whole edifice of the bank had already started to crumble; ignorant of the risk that had already materialized in the form of its toxic mortgage book. It had taken a gamble; blinded by the potential value without due diligence regarding the risk. Whatever compliance processes were in place at RBS, they were not up to the task of preventing the disaster that was just waiting to happen. Our analysis shows that lessons have still not been learned within the banking sector and many significant risks remain in commercial decision making[xxiii].

When a bank makes any business or commercial decision it can only be for one of two reasons:

- Will this decision maintain our standards and/or ensure we are compliant? or
- Will it add the level and type of value we need?

Perhaps a better and simpler illustration is to consider an airline: is the plane airworthy and will we make a profit from flying it? The airline industry is very rigorously regulated so that accidents rarely happen but airlines will, nevertheless, be tempted to create more profit by cutting

corners e.g. running on minimum fuel levels. Constantly getting the balance right is a key factor in mature, whole system management.

If customers know which airlines are 'cutting corners' they are unlikely to fly with them. The same principle applies to all organizations but the consequences are much longer term in banking, so the risk should be measured more often and more effectively; so that regulators and customers can take avoiding action much earlier if necessary. The only way to minimise these risks is to have every single person in the organization monitoring their work on a daily (even hourly) basis. This is why we developed a systematic approach to analysing human risk factors.

Banks that appear to have suffered (and sought to identify) a symptom of the so-called "rogue trader" (e.g. Kweku Adoboli at UBS, Jerome Kerviel at Societe Generale, and the "London Whale" at JP Morgan) have, in reality, been suffering 'rogue' human systems, which only come to light and are often later admitted to after the full financial consequences are discovered.

Bank OMR Risk Factors

OMR analysis provides an elegant solution to the question of balancing both sides of the value/risk coin. The OMR score (%) and Risk Factor (%) will always come to 100%. For example, Barclays OMR score of 23.90% produces a risk factor of 76.10% (a total of 100%). This is the basis for the chart in Table 8.

In simple terms if a decision does not add value it adds risk (e.g. wasted resources, missed opportunities etc.).

The OMR Risk Factor is specifically designed to incorporate the probability of any bank carrying undetected, material risk with respect to its governance and culture (G&C). It can serve as a predictive, long-term indicator risk that could manifest as catastrophic value collapse but will also pick up ongoing value erosion (e.g. reputational damage, poor customer service etc).

Bank (Human) Risk Factors	
Handelsbanken	17.40%
ING	29.75%
Goldman Sachs	30.05%
Santander	38.00%
National Australia Banking Gp	46.00%
Commerzbank AG	46.87%
Morgan Stanley	49.20%
Bank of America	51.18%
Lloyds Banking Group ORD	52.67%
Credit Suisse	52.85%
UBS	55.03%
Royal Bank of Scotland Gp	56.70%
Deutsche Bank	56.70%
Citigroup	57.47%
Wells Fargo	58.82%
Standard Chartered	59.37%
BNP Paribas	59.40%
HSBC Holdings	59.86%
JP Morgan Chase	63.17%
Societe Generale	64.88%
Barclays	76.10%

Table 8. Risk factors

The Risk Factors for each bank are identified in Table 8 with Handelsbanken bearing the lowest risk at 17.40%.

Handelsbanken mitigates most G&C risk through a coherent business model aligning purpose to value through all its human capital and effecting "control" through a healthy culture with high trust and autonomy.

For Barclays, its risk arises not only because of its inability to maximize the value inherent within its human governance systems but it is also an organization with myriad corporate failures arising from G&C: one recent example being the serious misconduct issue with respect to a whistle-blower[9], currently under investigation by US and UK authorities.

Bank risk assessment systems

Governance and culture risk arises out of equivocal, unclear or skewed organizational purpose and values that permeate all company systems: from decision-making, resourcing, reward, learning and performance management to quality assurance. Only by understanding risk in this context is it possible to fully understand and predict the likelihood of corporate problems and failures.

One overall finding in terms of the banking sector's ability to manage G&C risk is that banks do not understand, nor appreciate, the whole system nature of the problem. More worryingly, despite the slew of misconduct costs that have arisen since the GFC, a number of banks remain incapable or unwilling to identify and confront the underlying root causes of inappropriate behaviours. Most recently, while Wells Fargo had to acknowledge its fraudulent sales practices it should also have openly recognised that such behaviours did not arise in isolation. The bank still struggles to see or accept the deeper nature of why these practices occurred. New CEO, Tim Sloan, has pinned the blame largely on incentive compensation within retail sales and the former head of retail[10] and seeking to blame, rather than owning the whole system, is a strong indicator of immature leadership.

We find that bank approaches to G&C risk assessment and management typically fall into the following categories:

1. The primary use of regulatory compliance and control mechanisms as a means of "policing" the organisation and aiming to satisfy external rules and regulations rather than adopting meaningful methods to make G&C an effective weapon against the incidence of risk.

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[9] https://www.ft.com/content/155df86c-1db8-11e7-b7d3-163f5a7f229c

[10] http://www.cnbc.com/2017/04/10/first-on-cnbc-cnbc-transcript-wells-fargo-ceo-tim-sloan-speaks-with-cnbcs-wilfred-frost-on-cnbcs-closing-bell-today.html

2. Investment in compliance and controls (particularly headcount) but without an explicit recognition and establishment of board level responsibility for G&C (such as the establishment of committees with G&C remit). Most banks were unable to provide clear evidence of coherent and robust frameworks to make improvements to G&C risk management. (See the HSBC report below as one example).

3. G&C is seen as critical to both value creation and risk management and management systems are created, specifically, to develop a mature, responsible culture as first line risk management. The 4 most highly rated banks understand this critical attribute and its contribution to knowledge sharing, decision-making, communication and alignment with underlying purpose and values. Consequently, their OMR Risk Factor is significantly lower.

HSBC: "Conduct & Values Committee

Role and responsibilities The CVC has non-executive responsibility for oversight of culture and conduct risk. It is responsible for HSBC's policies, procedures and standards and ensuring that the Group conducts business responsibly and consistently adheres to HSBC Values...... Principal activities and significant issues considered during 2016 **Conduct** During the year the Committee reviewed the implementation of the Group's conduct approach and, in particular, how effectively global programmes were being cascaded through the organisation. **Sustainability** The Committee was responsible for reviewing how effectively the Group sought to satisfy itself that it was meeting its sustainability commitments. **Modern Slavery Act** The Committee and Board reviewed and approved the Group's Human Rights and Modern Slavery Act statement. Further information on conduct can be found in the 'How we do business' section of the Strategic Report and in the Financial Review." **2016 Annual Report**

Whole System Risk analysis: 12 Factor Risk Grid

Despite the GFC and the necessity for banks to build large internal compliance functions in response to regulatory requirements, governance and culture risk remains poorly assessed and managed. Such risk is often framed through an extremely narrow lens, such as banking "talent". For example, in discussing principal risks, HSBC identify one critical G&C risk as follows:

"We have increased our focus on resource planning and employee retention and are developing initiatives to equip line managers with skills to both

manage change and support their employees." HSBC Risk Overview 2016 Annual Report

Such an anodyne statement belies the true magnitude of G&C risk that HSBC is likely to be carrying but the bank attempts to reassure stakeholders that its compliance and controls will be able to police any misconduct, which it sees as driven by external factors outside the organization:

"We created a new function, Financial Crime Risk, which brings together all areas of financial crime risk management at HSBC and continued to enhance our management of conduct in areas including the treatment of potentially vulnerable customers, market surveillance, employee training and performance management". HSBC Risk Overview 2016 Annual Report

MI is not satisfied with such a narrative and adopts a whole system G&C risk analysis to identify the nature and quantum of business risk that is inherent within an organization. This involves analysis of twelve core, and interrelated, human capital risk factors that have causal connection to material business risk, as shown below:

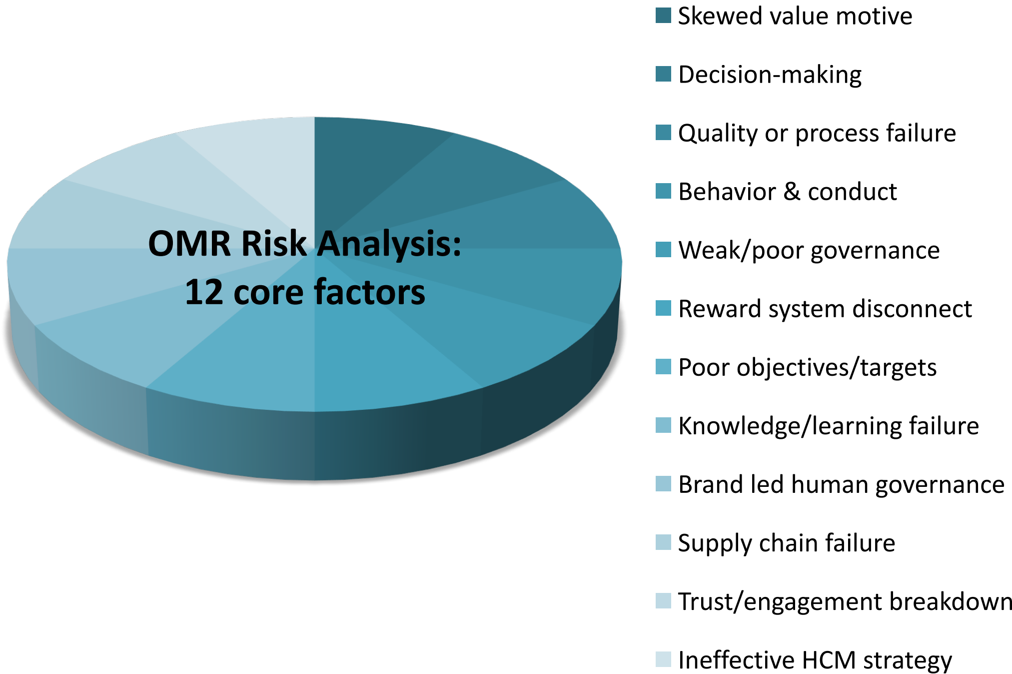

Figure 10. OMR Risk Analysis -12 Core factors

These 12 factors form MI's standard for G&C risk assessment and from the OMR analysis of the 21 banks, we find the following:

1. **Skewed value motive**: the nature of this risk arises from a strategic focus on one value variable to the detriment of others. For example, a 'Cost' efficiency strategy at the expense of the other value variables of Output, Revenue, and Quality that complete the net value picture.

   Most banks rated in our analysis have an underlying purpose geared to delivering shareholder returns. For those who have articulated a strategic purpose that is societal in dimension, only 3 banks have provided sufficient evidence that their societal purpose has been largely operationalized across their organization.

   In the absence of an operationalized societal purpose it is clear from our analysis that the, readily measured, financial drivers of value (i.e. simplistic and isolated measures of revenue and cost) are given a disproportionate focus within the banks. In fact, the ramifications of this misjudgement are compounded through reading across to incentives in executive remuneration. This has been an underlying driver of much misconduct as decision making, actions and behaviour become aligned with short-term profit making rather than delivering true value.

   With numerous examples to consider **Goldman Sachs** offers perhaps the most interesting because of its openness to admit that this is what happened to it post 2000. Shifting from a sacrosanct principle of "Long Term greedy" to chasing short term money, Goldman played its part in the GFC and was the first bank to offer up an apology for doing so[11]. It also acknowledged, subsequently, that this had caused the bank significant value damage. Since this time, it has been attempting to repair itself, and in the main, has managed to do so. This is not the case with many others who remain at risk because of the nature of how an underlying value focus translates into actions and behaviours.

2. **Decision-Making**: indicators here include a 'top down', driven organization that leads to poor decision making; a hierarchy that leads to slow implementation of decisions; an inability to embed new strategy, and unclear responsibilities with low accountability that cause inefficiency and ineffectiveness.

   RBS is an obvious case study of how decision making can become skewed under a dominant CEO (Fred Goodwin) and can ultimately contribute to the failure of an organization. **JP Morgan** is one bank that retains a dominant Chair/CEO and where decision making is likely to be far less collegiate and rigorous than at its peer group competitor,

[11] http://www.cbsnews.com/news/goldman-sachs-says-sorry-for-the-housing-and-credit-crisis/

Goldman Sachs, where their Chair/CEO presides over a very different type of organization. Anecdotal evidence suggests employees of JP Morgan and others of a similar ilk respect and admire Goldman Sachs for their culture at the top.

A number of banks also retain structures and cultures that discourage quick and effective change or market response. Such 'bureaucracies' remain legacies of many UK banks, something that challenger banks would like to exploit.[12]

3. **Quality or process failure**: this arises simply where quality control of a final product or service is a poor.

   The GFC provided many examples of unacceptable quality in bank services or products. Worryingly, many continue today. The corporate rap sheet of **Wells Fargo**[13] points to much deeper quality issues than one retail sales scandal suggests, while **Barclays** offers a long history of customer service problems[14] that have eroded value.

   Quality or process failures also arise from poor internal operations. For example, **RBS** have had a series of IT problems affecting customers in the UK, which points to an underlying management failure to deal with such issues[15].

4. **Behaviour and conduct**. This of course arises where Individuals or small teams in one or more locations behave or act such that catastrophic organizational damage occurs.

   Again, we have myriad examples among 20 of our 21 banks (chosen because of misconduct costs). **JP Morgan's** instances of misconduct include a recent "bribery" issue in China, a whistle-blower sacking and "mortgage abuses". As we highlight above, the concerning aspect of this is that the bank is either wholly unaware of, or in denial, about the extent to which this is symptomatic of its culture, simply stating in its 2015 Annual Report - "the conduct of a small group of employees, or of even a single employee, can reflect badly on all of us and can have significant ramifications for the entire firm." This statement fails to identify what, if any, remedial management actions are required and

[12] http://www.managementtoday.co.uk/why-metro-banks-vernon-hill-isnt-afraid-lloyds-barclays-blockchain/entrepreneurs/article/1416276

[13] http://www.corp-research.org/wells-fargo

[14] http://www.cityam.com/259296/these-uks-best-and-worst-banks-look-away-now-barclays-users

[15] https://www.theguardian.com/business/2017/apr/28/rbs-and-lloyds-it-faults-cause-online-banking-frustrations

has significant implications on the ability of such large banks to govern themselves such that they can avoid material damage to wider society.

5. **Weak or poor human governance**: ineffective governance starts with poor clarity in organizational purpose and a weak societal value motive. Good human governance also requires expertise to assess and resolve key issues.

   Like most corporate organizations, the banks we have analyzed are unable to realize value from their underlying purpose and have little to no effective senior leadership capability in this critical area. Consequently, significant risk issues arise and go unmanaged for many.

   All the banks rated have seen serious human governance failures materialise e.g. money laundering, tax evasion, breach of economic sanctions or the facilitation of dubious and unethical business deals. Attempts to deal with these have largely been made through compliance and control measures, which as described above, are an inadequate response. In short, unhealthy or toxic cultures will eventually circumvent or undermine management systems and reinforce the aphorism - 'culture eats strategy for breakfast'.

6. **Reward system disconnect**: reward systems; from senior executives through to management and staff, do not relate to value and encourage other outcomes to arise.

   This is now widely recognized as being endemic in the majority of corporations as we have detailed in our executive remunerations section above. Exceptions are few and **Handelsbanken** and **ING** are rare exemplars in this respect but it is good to hear John Cryan at Deutsche Bank[xxiv] decrying the need to be paid a bonus for a job well done.

7. **Poor objectives or targets**: arise from excessive, meaningless and/or conflicting performance targets & KPIs that drive adverse outcomes.

   In a mature organization the intrinsic philosophy of never-ending, continuous improvement, combined with value being the only goal worth setting, renders targets and 'performance objectives' outmoded. Many banks and some regulators have identified sales targets as a key problem and a source of skewed incentive that needs to be fixed. However, this fails to identify the full depth of inappropriate targets that are arising across most banks and which can cause ineffective or damaging outcomes. For example, many companies use diversity targets or report on training days. Each fail to deal with a much bigger issue i.e. the generation of value from effective knowledge utilization

or the realization of value from available talent. Such targets say as much about poor leadership and management as inappropriate sales targets. And the use of such targets highlights the silo based nature of such organizations that fail to understand their corporations as whole systems.

8. **Knowledge or learning failure**: Failure to utilize existing, critical, internal knowledge which leaves the bank in a disadvantaged or precarious market position; or an inability to learn from mistakes or innovate for the future; causing material value damage

   We found only one bank had attempted to measure "Employee-led innovation". **Deutsche Bank** reported 2,456 employee ideas from a workforce of 99,744, which is an innovation or idea rate of 2.46%. This demonstrates the enormous value being lost when compared to OMINDEX A- rated Toyota, who have achieved c.500% per annum. All banks should be working on developing a value focused innovation system as part of effective culture change.

9. **Brand-led human governance**: A shallow search for 'corporate awards' ('Best Company' et al); 'tick-box' commitments to issues such as human rights, diversity quotas and the UN Global Compact and strong policing of internal and external messaging to ensure compliance with a "brand".

   Employer branding has its place in making banks attractive to potential recruits and in helping to galvanize existing workforces around meaningful achievements. Excessive use of so called awards and compliance with meaningless CSR indexes serves as a contra-indicator for OMINDEX rating. Banks who spend excessive time and effort on branding are more likely to be seeking to subvert reality and over-investment in such activity does not represent good value.

10. **Supply chain failure**: weak oversight of supplier leads to erosion of supplier product/service value; or disincentives for quality outcomes such as outsourcing purely to reduce costs.

    We have found little evidence of any bank creating value based supplier partnerships. Bank supply chains are less critical than in, say automotive and FMCG. Nevertheless, such relationships are a good indicator of an organization's ethos and actions to manage human capital value and risk throughout their wider network systems.

11. **Trust or engagement breakdown**: symptoms include a dysfunctional organization with an adversarial or hostile employee relations environment that damages value.

Many investors request the reporting of employee engagement survey results to consider this type of risk. We see these as limited or weak evidence in terms of typical survey design, data credibility and relevance. For example, Barclays have used their engagement survey to justify culture improvements, yet CEO Staley signaled a major contraindicator of positive culture change in seeking to identify a critical whistleblower. Staley's previous employer JP Morgan was also fined in late 2016 for the firing of a whistleblower. Both are telling symptoms of an adversarial or even hostile employee relations environment in each bank.

12. **Ineffective human capital strategy**: For example, a lack of due diligence on M&A and subsequent integration and insufficient attention to human capital aspects of M&A activity contributes to high costs of integration, subsequent under-performance & failure to match expectations. Human capital management (HCM) is evidently not built into long term plans such that strategic decisions create company vulnerability.

    Nearly all the banks rated have used acquisition strategies to grow quickly in recent times. It is evident that none of these banks took G&C as seriously as they should during due diligence; nor did they have the internal capability to measure or assess G&C fit.

    All such banks have paid a heavy price. Many operations remain largely fragmented, and consequently, out of step with HQ policy. From unrealized cost efficiency to human governance failures, excessive and rapid M&A growth has led to significant material risk manifesting and continuing to be carried by most of the banks rated. Most concerning is that few banks appreciate the circumstances in which they find themselves.

> *"One of the most difficult aspects is looking at the execution risk when you incorporate an organization in a different country, potentially with a different culture…We did the due diligence we were able to on every acquisition."* **HSBC Chairman Douglas Flint's evidence to the UK Government Treasury Committee in 2015, with respect to potential criminal activity arising via Mexican and Swiss acquisitions.**

SECTION 4. Practical lessons

What the banks need to do now

1. Re-visit your purpose and, where necessary, craft one that is clear and equates to a societal value of best quality at best cost (without undue external harm)

2. Define your value in terms of Output Costs Revenue Quality (OCRQ). For example, how many new accounts; at what average cost; expecting how much average revenue; and to what customer service standard?)

3. Declare your own human capital management standards such as for learning, executive remuneration, performance management (see MI as a guide http://www.hrmaturity.com/home/our-global-standards/)

4. Describe what good *human* governance and a healthy culture means in your bank and how your values reinforce this.

5. Ensure your board has the structure and capability to provide effective oversight of your governance and culture. Capability building can start here: http://www.hrmaturity.com/ihrm-events-201314/the-maturity-institute-orientation-programme/

6. Demonstrate your bank means to act upon weak G&C: take a banking & finance oath.

7. Start producing integrated reports to present a whole system picture (see AT&T example http://www.hrmaturity.com/wp-content/uploads/2017/02/ATT-Financial-Human-Governance-Human-Capital-Management-Report-1.10.pdf)

8. Specifically address the 12 Risk Factors and build them into your risk management system where they are absent.

9. Check all internal measures/metrics/performance indicators are connected to OCRQ or risk mitigation.

What the authorities and regulators need to do now

1. Make societal value the ultimate goal against which regulations are set.

2. Develop internal capability to assess G&C as a material risk

3. Match bank compliance against their OMR

What investors and asset managers need to do now

1. Factor OMRs into investment decisions

2. Check existing credit ratings against OMR to assess whole system portfolio risk

3. Use OM30 as a reference point for company engagement

4. Build internal capability in G&C assessment and rating

What auditors, accountants and CFOs need to do

1. Build a more integrated reporting system that incorporates every aspect of OM30.

2. Audit human systems that undermine or reinforce all other control systems using the OM30 instrument.

How the Maturity Institute can help you: *join the Maturity Institute for further development in whole system management and learn how to rate your own bank or those you work with.*

Appendix 1 - OM30 Questions

OM30+ Scoring & Rating scheme	
Q	**Element**
1	**How authentic is your company?** Are all the company's claims true? Is there a tendency to hype and PR spin? Score between 1 (inauthentic) and 10 (perfectly authentic)
2a	**Company purpose** Does the company have a clearly stated purpose somewhere (e.g. annual report or website). Score 1 for YES or 0 for No?
2b	**Society benefit.** Do not score this unless you already answered 'Yes' to 2a. Is that purpose focused on providing the best quality product/service at the lowest cost? If yes, score 1.
2c	**Does everyone in the company understand and aim to acheieve the purpose?** If you answered yes to Q. 2b. Then a yes to this question scores 1.
3	**What is the most valuable aspect of your company?** Do you dominate the market; is your customer srevice top class; will you not be beaten on price? Score between 1 and 10 for just how much of a sustainable advantage this gives you.
4	**Are the company's market value & human values** totally coherent and consistent? Are you abusing your market position? Are you constantly having to check and steer the behaviours of your people?
5	**Governance** Does anyone on the board hold specific responsibility for human governance?
6	**Trust** Is your company trusted by its customers, employees, shareholders and other key stakeholders?
7	**Values** Can you identify 3 core values that are clearly evident in your company? Score 1 for each value identified and 1 for each where there is clear evidence the values are lived.
8	**Principles** Can you identify 3 principles that are clearly evident in your company? Score 1 for each principle identified and 1 for each where there is clear evidence they are practised.
9	**Value potential** To what extent does your company aim to maximise the value it generates from all of its human capital (staff/suppliers/society)?
10	**Vision** How far ahead does your company see?
11	**Mission** Identify the top priority that must be achieved within 3 years. Score 1 for a Mission statement and plus 1 if it is clearly stated in potential value terms of growth, market share, new product development etc.
12	**Integration of human capital & business strategy** What evidence is there that the organization adheres to a policy of - "If we are to maximize the value of the business we have to make the best use of the total talent pool available and maximize the full value of our human capital; requiring our suppliers to do the same."
13	**Accountability** What are the Board and CEO accountable for?
14	**Strategic cohesion** To what extent do leadership, management and staff understand and work cooperatively towards a coherent set of strategic goals?

15	**Culture** What evidence is there that the Board recognises that constantly monitoring culture is material?
16	**System** To what extent does your organization operate as a coherent and cohesive whole system?
17	**Business planning** To what extent are improvements in the organization's capability in human capital management specifically factored into its current business plan?
18	**Evidence-based management (EBM)** To what extent are management decisions based on evidence?
19	**Never-ending, continuous improvement** Is everyone in the company expected to continuously improve the business?
20	**Quality system** Is there a rigorous quality assurance system in place?
21	**Innovation System** Does the company have a system to measure the rate of innovation from employee ideas?
22	**Performance management system** Is individual and company performance managed systematically?
23	**Learning & knowledge** Does the company actively encourage everyone to learn and share what they have learned?
24	**Identifying the specific value impact expected from human capital** Does the company factor into its business plans exactly how employees will be affected?
25	**Return on human capital** Has the company ever produced an ROI calculation for what it expects from an investment in its people (e.g. training, development, employee ideas etc.)?
26	**Cooperation** Is it generally a company with willing and enthusiastic cooperation from everyone (including suppliers)?
27	**People risk** Does the company take employee risk seriously and are you aware of the existence of a people risk assessment?
28	**Remuneration & Reward** Does the company have a clear policy and are the rules easily understood?
29	**Communication system** How much importance does the organization attach to communication and is there a system in place to ensure it is working?
30	**Organizational agility, adaptability and flexibility** How well does the organization adapt to changing market conditions with a minimum of risk, cost and business disruption?
31	**Stakeholders** Whose interests, among all of the organization's specific stakeholder/s, are given primacy?
32	**Decision making environment** To what extent would you describe high level decision making in your organization as collegiate?

Appendix 2

Banco Santander – Summary of OM30© analysis

A Maturity Institute Project
Banking Sector Governance and Culture

Banco Santander:
OMR BBB; Total Stakeholder Value[xxv] 0.533
Risk factor[xxvi] 38%

OMR – RATING/RISK GAP

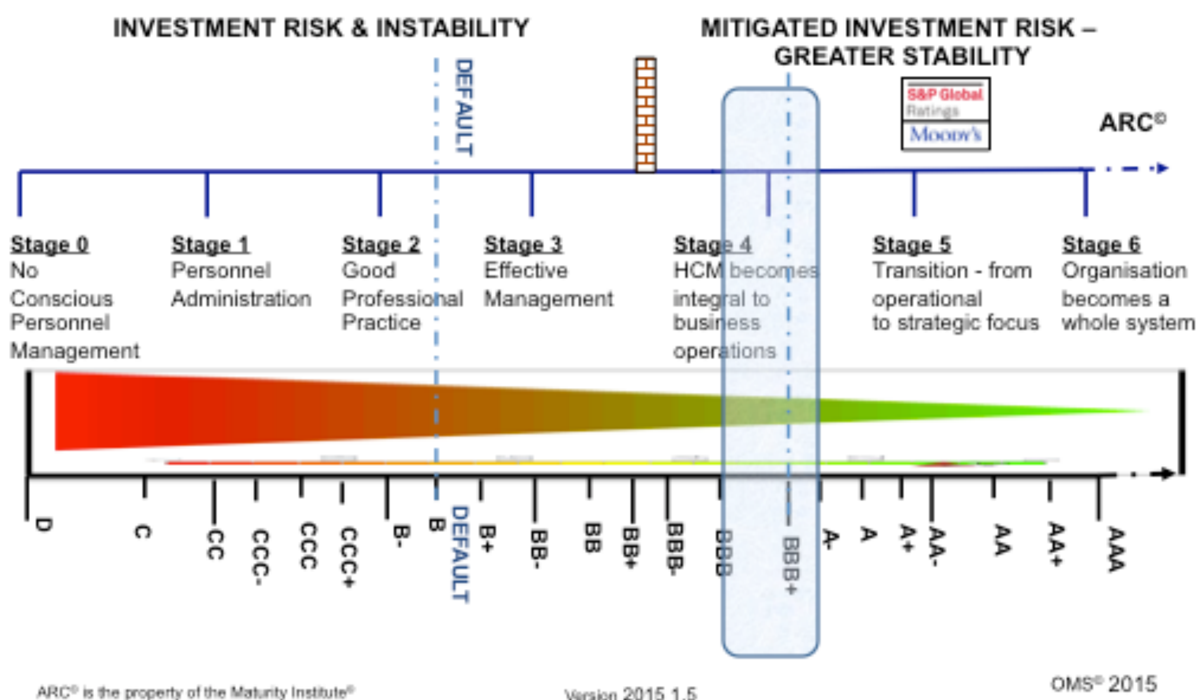

Figure. 1 Santander has an OMR "BBB" rating only two grades below its A- credit rating (S&P)

1. Authenticity of the organization's public statements and external communications and the reality found in the evidence appear reasonably aligned. However, the significant effort focused on

‘employer branding’ initiatives provides limited insight into the veracity of Santander’s declared purpose, principles and practices and little insight into value creation.

2. The Banco Santander organization has a long history but its current business is comprised of relatively recent (primarily international) acquisitions. It is evident that Chairman Botín understands the need to create an operational and cultural ‘whole system’ but this remains a work in progress to achieve the desired level of global coherence, as exemplified by its 2017 governance goals (2016 Annual Report, p.95).

3. Chairman Botín has been in place for over 2 years and was long groomed for the job of heading her family’s bank. The stability and stewardship provided by a family member with such domain knowledge of the banking industry augurs well for the sustainability of value at Santander.

4. Banco Santander has a clear societal purpose and mission, defined in operational terms as: *“operational excellence: to increase customer satisfaction by offering the best service at the lowest price possible.”* (2016 Annual Report, p.35), which mirrors MI’s own standard for Total Stakeholder Value. This is supported by evidence of good customer satisfaction, strong operating margin and a low cost-income ratio.

5. CEO and executive remuneration has a number of sound principles with a recognition that total pay has to remain proportional in a wider company context. However, it remains primarily driven by financial targets (80% weighting on variable pay – 2017 AGM proposal) and is not adequately aligned to key value and risk drivers as defined by MI’s global standard of Total Stakeholder Value (TSV).

6. Santander’s Board includes typical committees and remit; however, the use of a committee to oversee innovation (product and operations) is noted as a positive signal to create a culture of ‘never-ending improvement’ from the top of the organization, although there is no evidence of a measurable innovation system meeting MI standards.

7. Santander has created a “subsidiary” business model seemingly allowing significant autonomy and responsibility to local banking personnel. This can have powerful outcomes but requires robust management systems and sophisticated practices to create a

virtuous whole system – something that is noted as a work in progress.

8. Customer service is seen as fundamental to driving *loyalty* and value creation. There is good evidence of strength here although Santander has not been immune from misconduct issues, especially in the US.

9. Santander has identified "governance and "culture" as critical to both value creation and risk management. Its risk management reporting is impressive in a human governance context, particularly relative to peers and covers most issues identified in MI's risk grid standard.

10. Management practice deploys conventional HR processes focusing on talent attraction and retention, with a significant emphasis on employee engagement. This has a limited, and potentially misleading, link to material value and risk and does not meet MI standards of mature human capital management.

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[ii] See 'The Puritan Gift' page 266
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[xxiii] https://www.theguardian.com/money/2017/feb/10/are-car-loans-driving-us-towards-the-next-financial-crash
[xxiv] http://www.cnbc.com/2015/11/25/deutsche-banks-john-cryan-says-bonuses-dont-make-bankers-work-harder-says.html
[xxv] Total stakeholder value = P/B x OMINDEX rating
[xxvi] Risk factor = 100% - OMINDEX rating. This identifies the probability of material value loss and unrealised organizational value