Fit for Purpose?

By STEPHEN SCOTT
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The COVID pandemic has made business 'resiliency' a key priority. To safeguard such, financial institutions, their regulators and auditors, should examine whether their approach to conduct risk governance and supervision is 'Fit for Purpose.'

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CASE STUDY: CREDIT SUISSE

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Credit Suisse is been embroiled in a series of crises stemming from lapses in its financial risk governance practices.[1] In the last year: it was caught up in alleged fraud at Chinese coffee house chain Luckin Coffee;[2] exposed to the fraud-driven collapse of German payments company, Wirecard;[3] indicted in Switzerland over alleged dealings with a Bulgarian cocaine smuggling operation;[4] and it has faced enforcement action from the Swiss Financial Market Supervisory Authority (FINMA) in connection with an expanded spying scandal that involved surveillance of its own employees, ordered by the firm's COO.[5] In March this year, the firm said its clients could lose up to $3 billion from frozen funds linked to collapsed specialist finance firm Greensill Capital.[6] In April, it announced that it would suffer a $4.7 billion hit triggered by the meltdown of Archegos Capital Management.[7]

On the surface, these seem to be financial risk related mishaps. But it has recently emerged that Credit Suisse ignored warnings before Greensill and Archegos imploded.[8] In the case of Greensill, senior risk executives—to include the bank's chief risk and compliance officer, Lara Warner—overruled risk managers in approving further business with the already imperiled Greensill.[9] In interviews with the *Financial Times*, six current and former Credit Suisse managers said the bank had hollowed out risk expertise to favor promoting sales. Dissenting voices were suppressed. "There was a dulling of the senses," said a former executive. "There was systematic insensitivity at all levels," said another.[10] Warner was ousted late last month.[11]

NON-FINANCIAL RISK *IS* FINANCIAL RISK

The reported suppression of dissenting voices at Credit Suisse illustrates the importance a 'psychologically safe' workplace culture, as Harvard's Amy Edmondson styles it.[12] "Psychological safety is present when colleagues trust and respect each other and feel able—even obligated—to be candid," she writes. At Credit Suisse, it appears that such candor was unwelcome and dismissed. In her landmark study, Columbia sociologist Diane Vaughan found that the *Challenger* disaster was a "socially organized" outcome — one that illustrates "how deviance in an organization is transformed into acceptable behavior." What is "a dulling of the senses" and "systematic insensitivity" if not textbook examples of what Vaughan has termed the "normalization of deviance?"[13]

In December last year, CEO Thomas Gottstein promised to put legacy scandals behind him and to start 2021 with as clean a slate as possible."[14] But Credit Suisse may be struggling with a problematic *cultural* legacy and it is not clear that the firm's efforts to manage that challenge is "fit for purpose."

Like many firms, Credit Suisse appears to take a 'detect and correct' approach to its risk governance, at a time when regulators, investors and prosecutors are calling for a 'predict and prevent' approach that protects shareholder and broader stakeholder interests *proactively*.

As Gottstein contemplates next steps, he might benefit by viewing his task not as a *methodological* challenge (better processes and systems) but, rather, a *conceptual* challenge—one that requires new thinking about how risks may often flow from the relational dynamics among people. The crises in which Credit Suisse is embroiled appear to stem from *non-financial risk* challenges—challenges that stem from a culture which drove damaging decision making and conduct.

CASE STUDY: EY—GERMANY

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The *Financial Times* has chronicled the collapse of Germany's Wirecard closely along with a related collapse in confidence suffered by the firm's long-time auditor, EY. The now well-known fraud at Wirecard appears to have started over a decade ago.[15] Why did so few of those internal to Wirecard see fit to report misgivings, and how did its outside auditor fail, over several years, to uncover what in hindsight appears to have been a fairly obvious fraud directed by the firm's senior-most executives?

Reports are that an internal Wirecard whistleblower did in fact warn EY of the fraud, four years before the company's failure.[16] A subsequent investigation found that EY's fraud team shared this information with audit colleagues on the Wirecard account, amidst an audit of the company's 2017 annual results, and repeatedly pointed out problems into March 2018.[17] In June last year it emerged that EY had failed—inexplicably—to check on Wirecard bank statements for some three years.[18] In November, German audit industry overseer 'Apas' reported EY to prosecutors, alleging that EY may have acted criminally in its work at Wirecard.[19]

Earlier this month, the head of the EY fraud team who had sounded the alarm was called to testify in hearings before the German Parliament. That the red flags he and his team had waved before audit colleagues went somehow ignored is, he stated, "incomprehensible."[20]

But is it? Or were the cultures at both Wirecard and EY akin to what appears to be the case for at least some groups within Credit Suisse, where a lack of psychological safety led otherwise well-intentioned professionals to keep their heads down and their mouths shut amidst an obvious normalization of deviance? Such questions are being asked as the scandal has engulfed German politics. Bundestag MPs are asking why Germany's key financial sector regulators were so slow to recognize the gravity of the situation at Wirecard. "No government agencies played any role in uncovering the crime — neither BaFin, nor the FIU, nor the public prosecutor," one complained during hearings. "Wirecard is the latest in a whole series of financial scandals in Germany that BaFin failed to uncover," said another.[21]

Rather than scrutinize Wirecard, BaFin instead worked to thwart *Financial Times* investigative journalists and issued a ban against traders short-selling Wirecard shares—despite having received warning from the German Bundesbank about taking such a step.[22] BaFin President Felix Hufeld has said that believed the FT journalists and short-sellers might be in league. Pointing to their "cultural background" Hufeld argued, "It cannot be ruled out that this is a matter of a network-like structure ('insider ring')."[23]

It is likely that inside networks will have played some part in this drama. But perhaps not the same networks Hufeld had in mind.

Hufeld was forced to step down from his role at BaFin in January this year.[24] The head of the Financial Reporting Enforcement Panel, Germany's accounting watchdog, stepped down in February,[25] as did the head of EY's German business.[26] The Wirecard /EY debacle, with its echoes of the fraud at Enron that caused the collapse of Arthur Andersen, has sounded a call to action for global regulators,[27] even as German auditors are fighting to avoid tighter regulation.[28] PwC pledged last summer to do more to try and detect fraud in the course of its audit work.[29] The next month, in a letter to clients, the Chairman and CEO of EY Global, Carmine de Sibio, wrote that auditors should "play more of a role in the future to detect material frauds."[30] But the audit firms are fighting a rearguard action. In April this year, the Bundestag announced an extension of its probe into EY's audit work at Wirecard.[31]

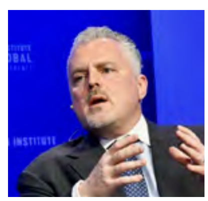
RETURN ON RISK?

Credit Suisse reportedly earned a total of $17.5 million in fees from its dealings with Archegos—a client that looks to have cost the firm $5 billion.[32] EY reportedly earned approximately $10 million in fees through its audit work at Wirecard over a period of ten years.[33] The ensuing damage to their reputation is immeasurable.

In both cases, compliance systems and audit processes uncovered the causal risks. Risk staff sounded warning bells at Credit Suisse. Evidence of the fraud at Wirecard was apparently so obvious that it was spelled out in detail by investigative journalists over a period of years. Former FinCEN head and, at the time, Deutsche Börse Group Compliance Chief James Freis was brought in to Wirecard last summer to shore up faith in its compliance function.[34] Freis spotted the fraud almost immediately and, after calling it to the attention of the firm's supervisory board, Freis was elevated to replace the disgraced CEO Markus Braun, now in prison.

"The most notable lesson here on the topic of culture, Freis writes,[35] "is the failure of individuals to speak up ... particularly as many likely knew enough to have formed dissenting views."

The Basel Committee on Banking Supervision defines operational risk as that flowing from "inadequate or failed internal processes, people, and systems or from external events." Credit Suisse, Wirecard and EY can point to robust risk management systems, processes and safeguards against external threats, none of which sufficed to overcome the internal risks that flowed from the behavior of their people, who were silenced by cultures that squelched psychological safety and allowed for a normalization of deviance to become deeply entrenched.



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