

A close-up photograph of a hand holding a thick stack of Euro banknotes. Below the hand, a black tray contains several Euro coins of various denominations. The background is a textured, light-colored surface.

Big Bonuses - Big Bang? ... How Rewarding Bad Behaviour Busted Our Banks

Ron Warmington, FCA, CFE

**Director, Fraud Management &
Security – GE Money Europe**

March 24th 2009

Banker visits JCB loan customer...



LONDON'S QUALITY NEWSPAPER



Evening Standard



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NEWS

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PAGES 8

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Free swimming threatened by £9m shortfall

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First.... a word on 'Gapping'...

- **When 'Greedy Bank' makes a 5-year, fixed interest-rate loan, in Polish Zloty, to its Customer... but finances that amount in the short-term Money Market, in Euros, it absorbs the following risks:**
 - **Credit (and Fraud) Risk (if/when the Customer concludes that he/she can't... or won't... pay)**
 - **Foreign Exchange Risk (Euro v Zloty)**
 - **Interest Rate Risk... known as 'Interest Rate Gapping'**
 - **Liquidity Risk ("Lending Long and Borrowing Short")... known as 'Liquidity Gapping'**
 - **Of all these, Liquidity Gapping is the one most likely to bankrupt your Bank !!!**

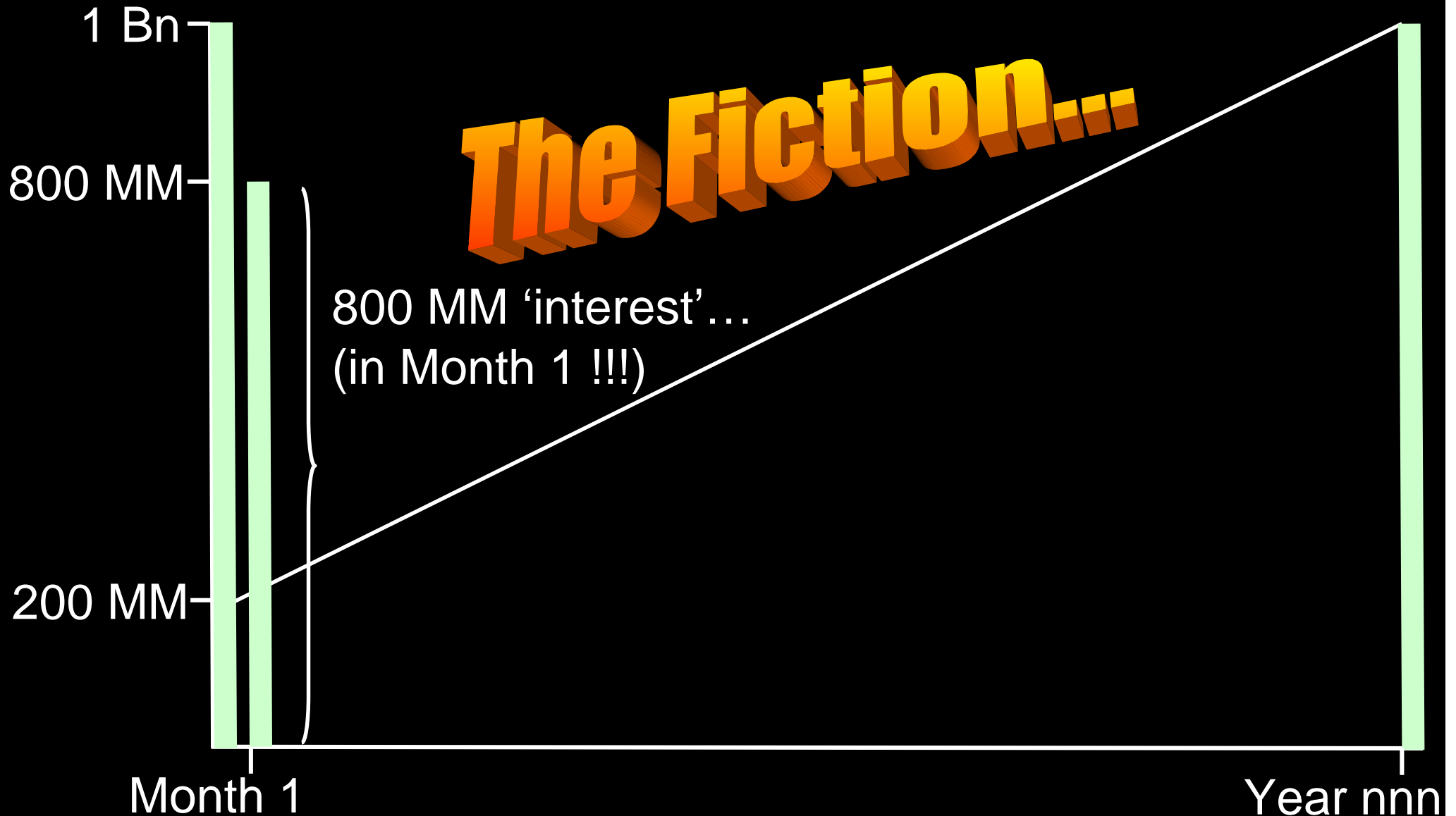
The Recipe for Failure ...

- **Poorly-designed Reward Systems**
- **Corporate culture dominated by determination to meet short-term / Quarterly targets**
- **Business Leaders typically in place for short terms (<3 yrs) so will often 'force' short-term profits at expense of long-term health**
- **'Star Players' who are 'Untouchable'**
- **Warnings ignored... and Boards staffed with 'Yes Men' (no 'Contrarian View')**
- **'Orphan' Businesses / 'Silo Mentality'**
- **Management who lack the courage to challenge, or to admit they don't understand**

Case Study: How to Screw Up...

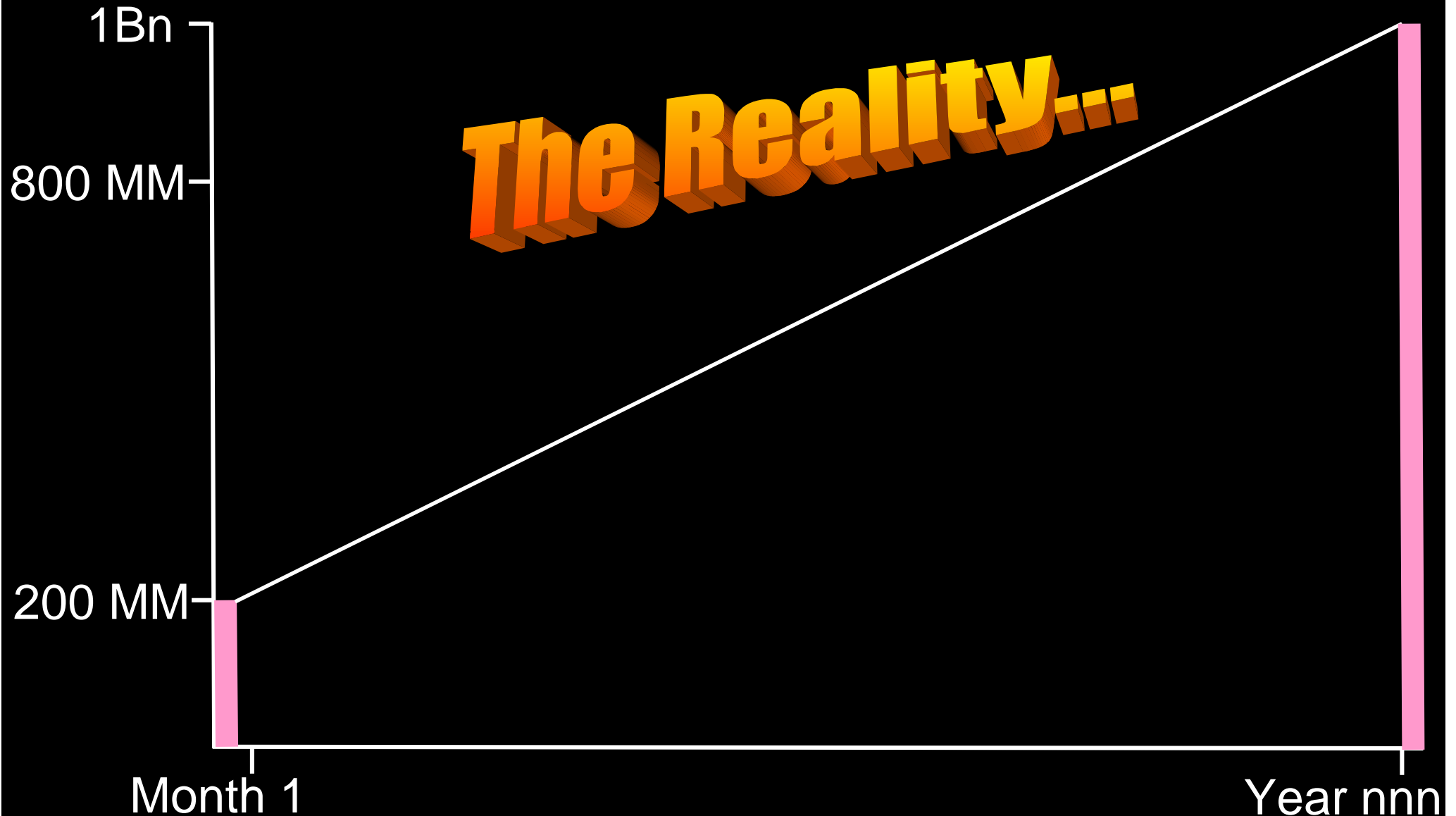
- Greedy / Ambitious CEO seeks to impress
- Prior Reward System thrown out in favour of one that forces Fee Income
- Sales-focussed 'get-rich quick' team brings in 'Structuring' deals that look 'Too Good To Be True'
- **Two examples:** The 'Billion Dollar Synthetic' & The 'Chest of Drawers'

Example 1: The Billion Dollar Synthetic...



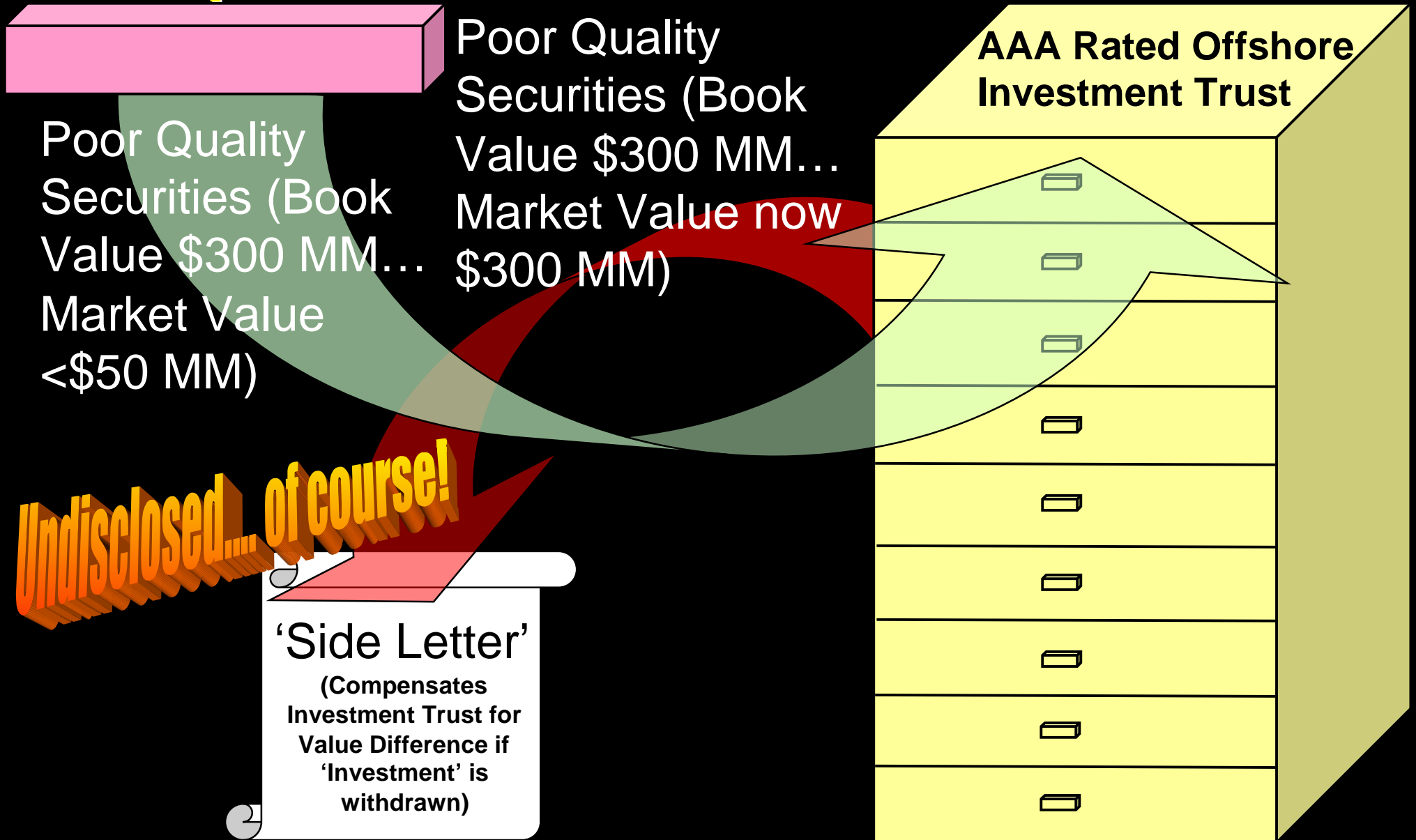
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Example 1: The Billion Dollar Synthetic...



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Example 2: The Chest of Drawers...



Case Study: How to Screw Up...

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- Prior Reward System thrown out in favour of one that forces Fee Income
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- **Two examples:** The 'Billion Dollar Synthetic' & The 'Chest of Drawers'
- Contrarians fired
- High-fee-rate deals go badly wrong... Wall Street Journal reports... Business broken... CEO fired

13 Giant Red Flags that nobody noticed:

- 'Orphan', hardly-ever-visited, entities
- Obscenely high pay and bonus rates for the 'star players' and a 'Feudal' system where *they* reward their minions, even those charged with controlling their activities
- Traders who (seem to be) making huge profits doing things nobody else understands (and nobody has the courage to challenge)
- Profit calculations and risk models that you need a PhD to understand
- Weak auditing – by the same person – for decades
- Frontline seniors who dominate – and know how to to over-ride or bypass – key controls
- Un-noticed / ignored Confirmation exceptions from counterparties

13 Giant Red Flags that nobody noticed:

- Management mesmerised by too good to be true 'super-profits' from 'living legend' untouchables who jump ship, when everyone else is asleep, as soon as they realize they've holed the hull below the waterline
- Businesses run by 'rags-to-riches' people with no relevant qualifications or past track record (and clearly no ethics)
- Business models that rely on the future being essentially a blissful extrapolation of the past... and...
- Reliance on 'The Market' to always be there to swallow ever more paper
- Gross exposure figures that a ten-year-old would realize made no sense
- Third party 'risk transfer' turning out to be a poor substitute for rigorous underwriting

Conclusion?...

Even the *smartest* people
will do the *stupidist things*
if the REWARD SYSTEM
motivates them to do that

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So... What can we DO about this?...

Go after those who have enriched themselves while accounting falsely and deceiving shareholders, creditors, staff, pensioners, etc.

How?...

- Choose your Targets VERY carefully
- Choose your Investigators and Litigators Carefully
- Remember... this is BUSINESS, not a moral crusade
- Make sure your likely reward will give adequate ROI
- Follow Gary's 'Ten Commandments'