COMMENTARY

For healthier European banks, turn off the dividend spigot

By Viral V Acharya, Diane Pierret and Sascha Steffen

New York

EUROPEAN banks' high litigation and restructuring costs have resulted in major losses on their books and abysmal stock-market performance. As the industry and European regulators now reflect on this dismal state of affairs and search for solutions, they should consider banks' revenue distribution – including employee bonuses and shareholder dividends – as part of the problem.

Revenue distribution is one primary reason for European banks' capital shortfalls. To understand why, we should look back to October 2014, when the European Banking Authority (EBA) began balance-sheet stress tests for the eurozone's 123 largest banks and found a capital shortfall of 25 billion euros (S$38.2 billion) in all of them.

At the time, the EBA required the banks to devise plans to address their respective shortfalls within 6-9 months. Some banks took action and raised equity through rights issues, sometimes with substantial help from governments. But most banks mollified regulators by simply shedding riskier assets to improve their capital ratios.

Needless to say, these efforts were ineffective, and European banks' share prices have declined by 50 per cent on average since the initial 2014 assessment. Banks that failed the stress test and didn't take the result seriously are partly to blame. But so too are regulators who did not sufficiently hold the banks' feet to the fire to improve their balance sheets, and who may have applied stress tests that were too weak to detect financial frailty.

The EBA conducted another series of stress tests and reported the results in late July. This latest round looked at 51 banks and, contrary to previous tests, was not designed to identify capital shortfalls, but rather to provide "a common analytical framework to consistently compare and assess the resilience of large EU banks to adverse economic developments".

Regulators now suppose that the European banking sector is resilient to adverse shocks. On the same day as the EBA's announcement, the worst performer (Italy's Banca Monte dei Paschi di Siena) announced 5 billion euros in new funding, pursuant to its 5.6 billion euro capital requirement.

Still, market reaction to the announcement was negative (the Euro Stoxx Banks Index fell 7.5 per cent in two days) – most likely because the EBA did not include specific estimates of European banks' capital shortfalls or outline a recapitalisation plan.

In a new paper investigating this market reaction, using United States capital-requirement rules, we calculate the total capital shortfall in all 51 participating banks to be 123 billion euros. Despite this large capital shortfall, 28 of the 34 publicly listed banks in the stress test paid out about 40 billion euros in dividends for 2015 – meaning that they distributed, on average, over 60 per cent of their earnings to shareholders.

Dividend payments made by undercapitalised banks amount to a substantial wealth transfer from subordinated bondholders to shareholders, because it is bondholders who will suffer the losses in a crisis. Moreover, it is potentially a wealth transfer from taxpayers to private shareholders, because under new banking rules, government bailouts are possible after bondholders have covered (bailed in) 8 per cent of a bank's equity and liabilities.

In contrast, undercapitalised banks in the US are forced to halt all forms of capital distribution if they fail a stress test. Fortunately, following the 2016 round of stress tests, the EBA is now also considering this type of regulatory sanction. Thus, "competent authorities may also consider requesting changes to the institutions' capital plan", which "may take a number of forms such as potential restrictions on dividends required for a bank to maintain the agreed trajectory of its capital planning in the adverse scenario".

We estimate that if European regulators had adopted this approach and forced banks to stop paying dividends in 2010 – the start of the sovereign debt crisis in Europe – the retained equity could have paid for more than 50 per cent of the 2016 capital shortfalls.

We have calculated capital shortfalls, using the EBA stress test's "adverse scenario" losses and the cumulative dividends these banks have distributed since 2010. Dividends paid out by some European banks (such as BNP Paribas and Barclays) actually exceed the current capital shortfalls while at others (such as Deutsche Bank, Commerzbank, and Société Générale), capital shortfalls far exceed dividends that would have been retained. The latter banks would still require substantial capital issuances on top of dividend restrictions to make up the difference.

Nonetheless, our findings suggest a simple first step towards preventing bank capital erosion: stop banks with capital shortfalls from paying dividends (including internal dividends such as employee bonuses). Such a policy would not even require regulators to broach topics like capital issuance, bailouts or bail-ins, and some banks have already even begun to suspend dividend payments. All that's left now is for the European Central Bank to enforce this practice across the eurozone. PROJECT SYNDICATE

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Britain should look east post-Brexit

By Mark Crosby

Melbourne

FOR Britain and the European Union, Brexit should be an opportunity to reset, not a time for retribution. The EU's overly ambitious but underachieving drive for economic centralisation has distracted from the desperate need for strong reforms in Europe's major economies. Outside the EU, the UK should focus on these reforms and engage with growing and dynamic regions of the global economy, while doing its best to continue engaging with its sclerotic neighbours.

From my distant vantage point, the debates preceding the UK's June referendum were "little more than the amusements of my daily newspaper" (to quote a famous Englishman) in that the impact for our region was likely to be trivial. The major EU economies have been shrinking rapidly in terms of their global economic weight for decades, and this has mattered very little to Asia's rapidly growing economies.

Furthermore, sensible attempts to revive and strengthen the economies of Europe, such as the reform programme outlined in the 2000-10 Lisbon Agenda, have come to very little. Weak demographics, high debt, and low productivity continue to bedevil much of the continent. Brazil, Indonesia and Nigeria could all have bigger economies than the EU by the end of this century.

This is the real issue with Brexit – will Europe find ways to revive, thrive and prosper? With the UK vote to leave, the question should be front and centre of the European debate about a post-Brexit EU. Instead, part of the focus has been on how to punish a recalcitrant UK – Robert Fico, the Slovakian Prime Minister, has said that he wants to make Brexit "very painful" and ensure that Britain is worse off outside the EU. This is despite the fact that such punishment would undoubtedly weaken the Union.

The UK's response should be to use Brexit as an opportunity to reposition its economy. The British Commonwealth is very limited in terms of its collective influence, but the English language and colonial links are a great springboard for a non-eurocentric Britain. Trade agreements with India, the US, Canada and Australia can be the starting point for greater linkages with emerging markets and the more rapidly growing advanced economies, as opposed to a shrinking Europe.

Australia is the only member of the Organisation for Economic Co-operation and Development to have enjoyed 25 years of uninterrupted economic growth. This growth has been driven by a heavy dose of economic reform in the 1980s and 1990s, low public debt, and a focus on engagement with regional economies. The share of Australia's exports to China, India and Japan has leapt to around 50 per cent in the past 25 years, while the share of exports to the EU has halved.

Engagement with Asia forces countries to think of competitiveness in a context in which demographics are young, growth is fast, and welfare and public debt are low. This will be the context for the global economy by the middle of this century. Looking to growing and dynamic regions of the global economy would prove that the UK not only realises there is a problem, but that it is dealing with it. The same cannot be said of the EU. OMFIF

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Values, values on the wall: Who practises, who recalls?

The Wells Fargo scam fiasco has produced no senior-level resignations at the bank to date nor any return of personal windfalls from the fraud. BY AVI LIRAN AND SIMON DOLAN

Wells Fargo's stock price dove after the scandal was exposed, shaving US$24 billion from the bank's investors. Some 5,300 employees were fired – but, surprisingly, very few senior executives. In fact, not even one senior executive has as yet taken any action that shows personal accountability. PHOTO: BLOOMBERG

ON SEPT 8, Richard Cordray, director of the US Consumer Financial Protection Bureau (CFPB), announced that Wells Fargo would pay US$185 million in fines for illegally creating unauthorised deposit and credit card accounts across the United States.

The saddest thing about Wells Fargo's fraud is that no one is surprised. As the leading Israeli humourist and gestalt master Lenny Ravich once said, "99 per cent of bankers give a bad name to this profession". We would go as far as to say: many bankers nowadays are ashamed to introduce themselves as "bankers" in public presentations.

Wells Fargo's stock price dove, shaving US$24 billion from its investors. Some 5,300 employees were fired – but, surprisingly, very few senior executives. In fact, not even one senior executive has as yet taken any action that shows personal accountability; there have to date been no senior-level resignations nor any return of personal windfalls from the fraudulent activities.

On the contrary, Carrie Tolstedt, the former head of the bank's consumer banking division – the executive directly responsible for overseeing its retail banking segment, where the fake accounts were created – was rewarded for her act. Instead of being fired and denied a bonus, in July, she was allowed to retire, holding roughly US$96.6 million in various stock awards.

Wells Fargo declares in its "Vision and Values" statement: "Leaders are accountable. They share the credit and shoulder the blame. They give others the responsibility and opportunity for success."

At the US Senate Banking Committee hearing on Sept 20, Senator Elizabeth Warren grilled Wells Fargo's CEO and chairman John G Stumpf on accountability. He could not properly answer questions regarding personnel, senior leadership resignations or bonus clawbacks.

This is not the first time in the history of business that greed overpowered values. A few years ago, BP compromised on its stated first core value of safety, causing the largest, most harmful and costliest oil spill in history that brought BP almost existential risk.

The cost of not delivering on organisational values is massive; today, many organisations are teaching their values in a very inefficient manner – only from the wall, rather than through their actions.

The note on the "Vision and Values of Wells Fargo", as spelt out on the bank's website in a multi-page document, states: "We believe in values lived, not phrases memorised. If we had to choose, we'd rather have a team member who lives by our values than one who just memorises them."

Most of the company's vision and values were breached in this fiasco. It wasn't a few rotten apples but, rather, 5,300 employees who broke the code of ethics. These employees didn't do it for a day or two; they did it daily over a period of a few years.

These employees deserve to be fired because they committed criminal offences; they cheated. Regardless of core values, virtually all societies see stealing as a criminal act. But when you are a low-wage employee whose livelihood depends on reaching an unrealistic sales target, you sometimes prefer to comply, especially if and when your colleagues are all involved in a fraud that clearly is making your bosses happy; actually, you are being taken advantage of by your superiors in the organisation. It seems that not only did the leadership not provide proper training and compliance controls, it is also avoiding taking responsibility.

On Sept 24, former and present Wells Fargo employees filed a US$2.6 billion class action against the bank in Los Angeles County Superior Court. The 26-page lawsuit states: "The biggest victims of this scheme are a class of people that nobody else has talked about. The biggest victims of Wells Fargo's scam are the class of victims that were fired because they did not meet these cross-sell quotas by engaging in the fraudulent scam that would line the CEO's pockets."

Senior executives at Wells Fargo might ask themselves: "What are we doing wrong in the hiring and on-boarding process? What training and compensation models encouraged so many of our employees or colleagues to cheat on our behalf?"

Wells Fargo did not practise the value of doing what's right for customers by faking their authorisations and charging them unknowingly. Did the leadership provide sufficient training for the values and code of ethics or supervisory effective compliance? How could they expect employees to follow the values while concurrently applying relentless pressure on them to achieve unrealistic sales targets?

> Nothing much will change unless we have a radical shift in mindset. There is an inherent conflict of interest in the current business model, where public companies appoint their boards and also appoint their auditors.

From a leadership perspective, cross-selling and providing one-stop-shop services for the financial needs of your customers is a legitimate goal. Yet, there must be a balance between "greed goals" that feed the stock value and practising the value of doing what's right for the customer.

If you were a CEO, would you fire two best-performing salespersons who contribute 60 per cent of your company's profits? Is it true that it is "kosher" to do anything for short-term share value growth?

In 2002, an internal investigation in Alibaba found two salespersons had engaged in bribery. Jack Ma, the company's founder and chairman, had a painful decision to make – and this at a time when money was essential for Alibaba's survival.

Mr Ma said: "If we fire them immediately, the company will not have profit. If we do not kick these two employees out, then what does this signify about us? It would imply that our words are empty. So we finally decided to let these two employees go."

He later said: "We focus on the employees and the culture. Everybody is helping each other instead of just making money."

Would Jack Ma have opted to pressure employees to meet sales quotas? He once dismissed a sales trainer for teaching malpractices. Said Mr Ma: "The training instructor was speaking about how to sell hair combs to monks. After five minutes, I got extremely angry and expelled the instructor. I thought the instructor was a cheat. Monks do not need combs in the first place."

In our work on coaching and managing by values across the world with many of the best global organisations, we continually see a crisis of "values in action". There is a growing discrepancy between the stated values on the wall and values in action. The most common current employee training methods largely reinforce values using a push strategy which relies far too heavily on memory and retention. Very few organisations actually practise what we and other like-minded value-driven consultants have been suggesting for the past 20 years. Many organisations remain fixated on the values their founders established years ago. Perhaps these values need to be updated.

A common "old" value that we see in many companies is teamwork. Is that a value or a result? IDEO, one of the world's most famous and successful design companies, chose to express teamwork instead as "we collaborate". These words have power. It is not a passive result but a dynamic action that inspires behaviour that drives results.

Organisations spend billions of dollars on engagement surveys, profiling tools and tests, yet they seldom ask about the personal values of their team members. As new generations grow into the workforce, there is a need to help them connect with the core values of the organisations they serve and take ownership of them.

Millennials are looking not only for values; they want to have a greater sense of purpose and meaning at work. Learning what their personal values are helps them to connect with their employers, to scan for similarities, and to develop respect for diversity.

This checklist may help you align your culture and values with those of your employees:

- Do you practise "hire and fire" for values? Do you emphasise attitude and suitability for your culture and values?
- Do you tolerate deviation from your culture and values, giving concessions and "closing one eye" when a top performer is needed for short-term results?
- Are your policies and processes aligned with your values? Do you create paradoxes by setting unrealistic targets?
- When was the last time you conducted a value audit to identify the current gap between the values on your wall and values in practice?
- With new generations of employees and disruptive technologies and business models, are your values still relevant? Do you need to refresh and update them?
- Are you at liberty to review and update your existing values? Are you willing to explore a change and solicit widely for feedback to uplift them or are you forced to live with the words on the wall?
- Do you provide tools to help the teams in your organisation understand the values of their team members?
- How do you teach your values? Do you emphasise only verbal memory retention or do you have procedures in place to ensure that values are actually living and put in action?
- Do you involve many of your employees in your strategic sessions or do you work traditionally top-down?
- Are the words on the wall empowering, vigorous and calls to action?

Nothing much will change unless we have a radical shift in mindset. We can't expect the cat to guard the milk. There is an inherent conflict of interest in the current business model, where public companies appoint their boards and also appoint their auditors. These individuals then get paid by the company and they have a personal interest to not lose their position by going against the management of the company – when sometimes they should.

In public companies, the role of the auditor is to protect the true owners of the company: the shareholders. Perhaps every stock exchange should nominate the auditors. If the audit firms get rotated every two years, the auditors will know that they too will be audited by a new firm, and thus be much more prudent. The public companies will pay a fixed fee to the stock exchange for auditing costs. When the auditors work for the exchange to represent public interests, they will be more impartial; their duty and loyalty will be to their clients, and the audited companies will be transparent.

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