AXIOM
ALTERNATIVE INVESTMENTS

ESG controversies in the financial sector

This document provides a summary of the most common and relevant ESG controversies that Axiom AI monitors to identify financial risks or opportunities.

1. Governance controversies

For any company, governance is at the heart of long-term performance. However, for financial institutions, the governance problem is even more acute, due to at least three reasons:

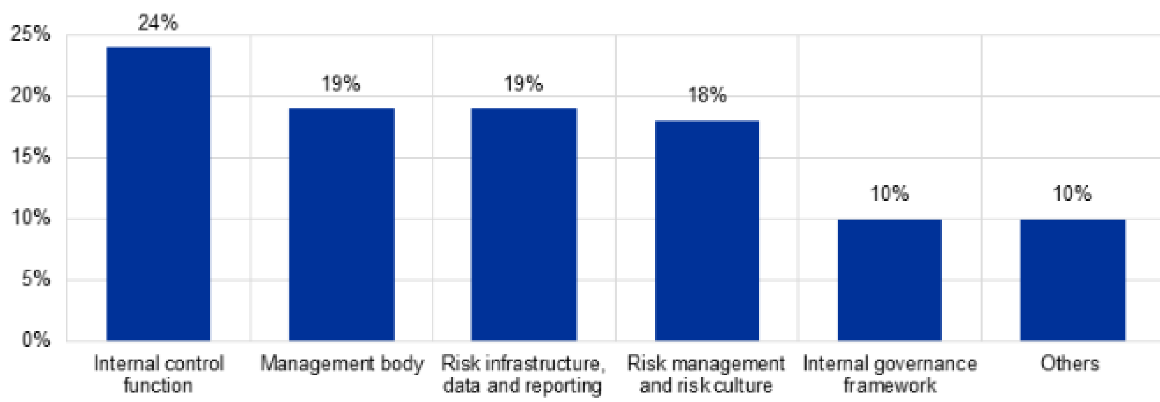
1. The massive conduct charges, credit losses, and the general public distrust that financial institutions have been facing since the last financial crisis cannot be adequately explained without a focus on governance. Financiers are often sophisticated economic agents who act under a set of external and internal constraints and maximise their (usually purely financial) payoff. One major role of an adequate governance system is to create adequate incentives within the organisation.

2. Finance is a very complex world: transactions are large and complicated, their risks are hard to understand, to report and to monitor. Therefore, an adequate governance system in the financial industry must not only set the proper incentives, but it must also address the thorny issue of getting sure that the board and executives are fully aware of what is going on.

3. The supervisory requirements on governance go way beyond what is applied to non- regulated sectors. Not only does the Basel Committee or local supervisors publish detailed governance best practices for banks, but they are also an important component of the annual supervisory review process used to determine each bank's capital requirement.

The complexity of this problem is best illustrated by the annual report on the SREP process published by the European Central Bank. The report states that "*Internal governance is the risk area which poses the greatest concern given the number of qualitative measures*" and "*30% of qualitative measures concern governance: the internal control function, the management bodies and risk infrastructure, data and reporting are the main focus areas*." ("Qualitative measures" are remedial actions requested by the ECB when it identifies a failing.)

Breakdown of 2019 qualitative measures by internal governance area:



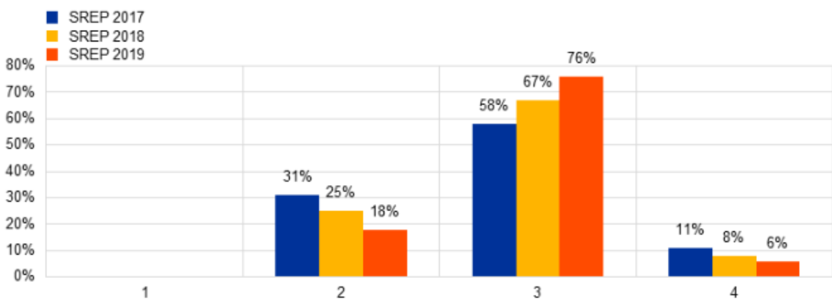
Source: ECB

Indeed, as the chart above demonstrates, corporate governance is not only about independent board members. The role of corporate governance at a financial institution covers a wide array of topics, all of which can have meaningful impacts on long-term performance, including:

- Setting the long-term strategy and objectives.
- Selecting and overseeing personnel.
- Managing day to day operations.
- Protecting the interests of many stakeholders such as shareholders, obligors, depositors and clients.
- Aligning corporate culture with integrity and compliance.
- Setting up adequate control functions.
- Defining the risk appetite of the institution.

Among those functions, those that concern the supervisors most are "*weak management board effectiveness*", "*weak risk management and control of outsourcing related risks*", "*poor data aggregation capabilities*" and "*weak anti-money laundering controls and procedures*". "*Proper incentives schemes*" are also a concern. Also worrying is the fact that banks do not really improve, as shown below (1 the best score, 4 the worst.)

Element 2: Internal governance SREP scores 2017, 2018 and 2019:



Therefore, Axiom AI believes governance considerations are key in the investment process. Our approach follows the traditional steps used by financial supervisors: the three lines of defence. These are the business lines, the board and the compliance function and internal audit. It equally focuses on the business ethics track record and related company culture characterizing the company.

a. the business lines

It is widely recognized among supervisors that the first "line of defence" against misconduct and inappropriate governance is at the level of the business lines, i.e. the business heads, regional heads or even desk heads. Supervisors have consistently claimed that this is where a cultural shift is needed most. Business units should improve their behavioural standards and their risk culture.

One major issue, which has been studied extensively, is the so-called "*trader-call*": traders may have a large bonus if their P&L is positive but do not face a negative bonus if their P&L is negative due to legal reasons. This means that they have a positive volatility exposure ("*positive vega*") and are incentivised to take risks. This is why the post crisis reform packages include a strong focus on compensation rules.

Based on regulatory filings and discussions with the management, we try to assess the effectiveness of the compensation packages and how well they handle the *"positive vega"* bias. This is not easy, because compensation schemes are often complex, can be tweaked, and banks are reluctant to give too many details. We generally look at the following aspects:

- Absolute amount of compensation. We recognize the value of rewarding excellent work, but also believe trading P&L does not grow on trees and very large compensations necessarily create dangerous incentives. For example, we note that the banks that had the largest trading P&L before the crisis are often also the ones that subsequently paid the largest fines for misconduct or market manipulation.
- Stability of the rules. Rules that change often are often the sign that the management wants to pay some predetermined amount of money and will tweak the rules to get to that amount. For example, pay-out ratios should not increase when revenues are lower. On the contrary, research

has shown that simply keeping the same level of risk-taking incentives will lead to higher risk in a downturn, suggesting lower pay-out should be used in such situations[1].

- Quality of disclosure.
- Technical details of the compensation plans. We specifically focus on the share of deferred compensation, on the P&L hurdles if any, on the instrument used to pay (we believe shares are not always appropriate) and on the existence of bonus caps and floors, including claw back mechanisms. We favour plans that are consistent with the research produced by the Bank of England on bonus caps and floors.
- Direct link between sales targets and bonuses. Supervisors have strongly expressed the view that compensation should not be directly linked to sales targets, as this creates strong incentives for short mis selling. Unfortunately, this information is rarely available.

However, compensation is not the answer to all problems. It is also not the only way the first line of defence can be improved. It is often difficult to get information on other topics, as financial institutions tend to keep the information confidential. When available, we try to obtain information on the following:

- To what extent is the middle management involved in promoting sound culture, effective governance and appropriate risk taking that is consistent with the risk appetite guideline of the bank (some middle management tend to act as mere “mailboxes” from front- officers to senior management).
- Diversity in the business lines. This is not about showing politically correct statistics, but about having a diversity of points of view within business lines and the organisation. Academic research (e.g. by the Bank of England) has shown that male and female front-officers do not have, on average, the same risk-taking behaviour when faced with the same risks and compensation incentives.
- To what extent, in addition to financial means, is the middle management directly incentivized to promote sound governance and culture, and how clear are the expectations communicated to them? Clarity of the definition and management of this risk is often lacking.
- Is conduct/governance risk included in the risk appetite statement of the bank and how is it managed, measured, and controlled at the business line level?

b. the board

The board is the goalkeeper, “*the last line of defence in the battle against flawed decision- making*” (Mr. Enria). When we look at the efficiency of a board, we consider the following:

i. Organisation

The board is more than the sum of its members: the way it works and the tasks it deals with are also crucial. As much as possible we assess the following aspects, using regulatory filings:

[1] See for example “CEO Incentives and Bank Risk over the Business Cycle”, Ongena, Savaser and Şişli-Ciamarra, 2018

- Group of 30 recommendation 1: Is there a specific committee dedicated to the culture of the institutions?
- Group of 30 recommendation 2: does the board have regular access to the businesses, via meetings with heads of business units and geographies or otherwise?
- BIS recommendation: does the board oversees the implementation of governance principles at lower echelons and periodically review it?
- BIS recommendation: does it define the risk appetite of the firm and periodically review that it is adequate, considering market changes, and that it is appropriately implemented?
- BIS recommendation: does the board defines the internal capital requirement and the appropriate buffer above regulatory requirements, considering the firm's risk profile and monitor its adequate implementation?
- BIS recommendation: in addition to top management compensation, does it approve the compensation structure at the business level?
- BIS recommendation: Does it oversee the procedures for whistleblowing?

These tasks cannot be efficiently performed by all the members of the board**. To allow a deeper focus in specific areas we believe it is important for the board to delegate its work to ad-hoc committees which should each have a very detailed charter setting out its mandate, scope and working procedures.** The chairperson of those committees should be both independent and non- executives. Of particular importance, are the following committees.

- Audit committee. Although this is not a legal requirement in Europe, we believe all members should be independent or, at the very least, non-executive. We also believe there should be no related party transaction between members and the institution. We try to monitor whether members have audit and accounting experiences, whether they interact with internal and external auditors and if they have a say in their appointment, whether they oversee accounting practices and whether they meet often. We also check how long the auditors have been appointed as we observe very different practices in Europe (Lloyds has had the same auditors for 153 years, Deutsche Bank for 66.)
- Risk committee. We believe all financial institutions should have a risk committee at the board level, with an independent chair who is not the chair of another committee and with independent members to the largest extent possible. Obviously, members should have experience in risk management, a very technical field in finance. This committee should review the bank's risk policies regularly and oversee both capital and liquidity management as well as the usual "regulatory" risks (credit, market and operational.) The quality of the data received by the committee is also crucial (see c. below).
- Compensation committee. We believe all financial institutions in our coverage should have a compensation committee at the board level. The committee should not only focus on the compensation of the senior management but also work closely with the risk committee to examine if the firm's compensation policy creates perverse incentives.
- Nomination committee. We believe a nomination committee should exist, specifically tasked with recommending appointments to the board and of senior management. This committee should focus on assessing the knowledge, experience, competence and, where relevant, independence of appointees. It also should ensure that the board is not dominated by one individual or by a small group of connected individuals.

- Ethics committee. We believe an ethics committee should exist and should, in particular, deal with whistleblowing allegations. Members should be independent.

ii. Membership

The financial industry is extremely complex. **Board members must be up to their challenging tasks. We believe three main criteria should apply** (which is generally implied by the banking lingo "*fit and proper assessment*").

- Experience and knowledge. Not only academic knowledge, but knowledge grounded in solid real-life experience in the industry, including, if possible, in periods of deep crisis. We check the CVs of the board members and have a view on their "quality".
- Free from conflicts of interest. Personal transactions, other board memberships, significant investments, *etc*., should be monitored and assessed. The board should have rule in place to allow a member not to vote on a specific matter and to manage situations where conflicts of interest appear and are in breach of the board's own rules. We check regulatory filings with a particular focus on related party transactions.
- The diversity of board members is not a cosmetic requirement. It is about bringing diverse perspectives, experience, and knowledge, not simply about meeting gender diversity requirements. We examine whether there is a bias in the gender split of independent / non independent board members as this could be the sign diversity has been introduced at the expense of effective influence.

iii. Data Quality

As the famous computer scientist Wilf Hey once said, "*garbage in, garbage out*". The best board will never be able to operate effectively unless fed with adequate data - a task which can be extremely challenging when the firm is exposed to myriads of complex products, in many jurisdictions, with fast moving markets. During the 2007-2008 crisis, some banks were unable to manage their risks simply because they were unable to calculate and report on the risks they were taking.

Based on regulatory filings and on management meetings, we try to assess whether the firm complies with good risk data practices such as the Basel Committee standard on risk reporting. We mostly focus on the following items:

- The standards of validation of reporting tools should be high, well documented, and independently validated.
- Any new business development (acquisition, new products, etc.) should include a detailed analysis of its impact on risk reporting.
- The shortcomings of the risk reporting process should be well known, understood, and documented.

- A full data quality control process should be in place, both at the business line level and the risk level and should ensure that the bank's taxonomy (e.g. products, counterparty identification) is adequate.
- The bank should limit manual processes and desktop applications and the senior management should be well aware of their use and limitations.
- A global data dictionary is essential.
- All data aggregation processes should be documented, and manual involvement explained.
- The institution should be able to produce risk aggregated reports very quickly to match the speed of modern markets. Some items are more critical in terms of speed: aggregate credit exposure per borrower, counterparty credit exposure (e.g. on derivatives), trading exposures and liquidity indicators.

iv. Incentives

Executive board members should have a compensation package that creates virtuous long-term incentives aligned to those of all stakeholders. Our experience of the current practices show that institutions can offer vastly different packages, exhibit a varying degree of transparency, and often lack clarity on ex-ante goals.

When assessing the quality of the package we look for the following items:

- Transparency: how well is the package described and disclosed to investors.
- Types of ex-ante targets: we favour packages that:
  - Have explicit ex-ante targets.
  - Are not based on the share price.
  - Are not based on dividend payments.
  - Are based on medium term, risk adjusted profitability (internal capital modelling is preferred over regulatory capital allocation).
  - Do not have low goalposts (some institutions have target returns below their current returns)
- Flexibility: we favour packages that allow for flexibility, for example not paying huge compensation because of reduced tax rates or reducing pay out if management issues can be identified. Example include reducing pay out if AML issues or fraud are identified, such as at Well Fargo or at Goldman Sachs after the 1MDB scandal. However, that flexibility should not be an excuse to move the goal post in order to increase pay (e.g., reducing ROE targets for no legitimate reason)
- Deferral: we look for packages that allow for a significant portion to be deferred or even clawed back.

c. The compliance function & internal audit

Financial institutions must ensure that rules and guidelines set up at the board and executive management levels are effectively implemented at each business line's level. This requires both an ex-ante control of operations, this is the compliance function, and an ex-post analysis of what has been done, which is usually the role of the audit function. However, this general model is implemented in very different ways among firms. There is not yet a standard model for this second-line oversight of conduct and culture risk and the setup varies depending on the size, complexity, jurisdiction, etc. Auditing conduct initiatives, frameworks, and standards, etc., are particularly challenging, which means that compliance functions are sometimes too involved in their own audit.

When analysing the effectiveness of the governance of compliance and audit, we look for the following aspects in regulatory filings or by interacting with the management:

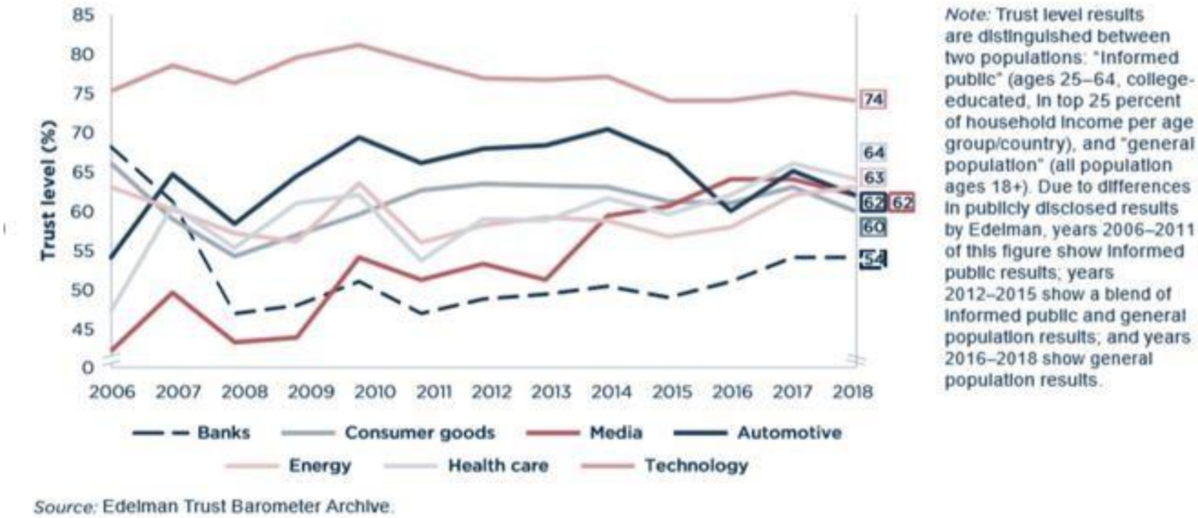
- Does the institution provide sufficient safety to encourage employees to speak up and escalate issues? This is crucial because we believe the financial world is so complicated, that front office employees are often the only ones able to understand when a conduct rule has been breached.
- Are conduct breaches genuinely and credibly sanctioned?
- Is the oversight of conduct risk clear and well organised, with written procedures, governance, and control mechanisms, and are those shared by human resources, risk, and compliance in an efficient way?
- Are compliance functions independent and well-staffed and do they have an easy and direct access to the top management?
- Is compliance involved before any new product is approved and is compliance involved in the monitoring of existing products? This is especially challenging for jurisdictions which are far from the firm's headquarters.

When possible, we benchmark compliance costs, to identify possible outliers that cannot be simply explained (for example by geographical footprints). We also monitor Deferred Prosecution Agreements (DPA) in the US as these are usually linked to improvements in compliance or audit functions.

d. Business Ethics and company culture

Ten years after the great financial crisis, financial institutions remain unloved. Banks are very often associated with poor ethics, inappropriate behaviour, or short-term greed at the expense of long-term return. This is best illustrated in the Edelman Trust Barometer results by industry sector for the years 2006-2018.

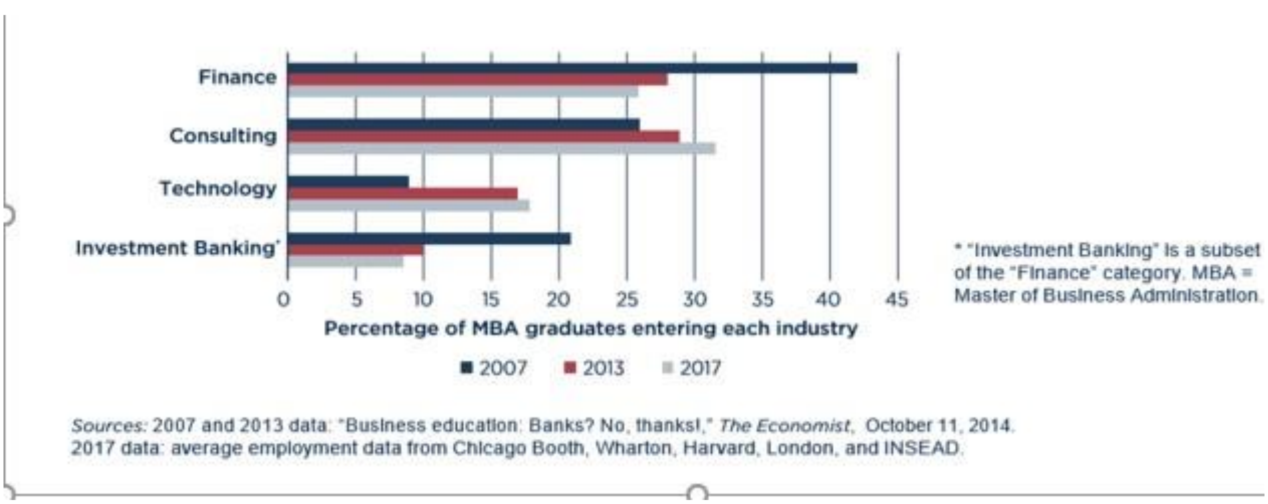
Edelman Trust Barometer results by industry sector for the years 2006-2018



This is not simply a theoretical or a perception problem. Bad culture is incredibly expensive. Over the past ten years, it is estimated that banks have paid more than US$450 billion in fines, settlement, litigations, etc., directly linked to general misconduct[2]. But recent cases have shown that this is not limited to large banks or to banks from a specific jurisdiction. Only last year, several small banks were involved in misconduct causes related to money laundering allegations. **Culture is not only essential to sustainability, but also a key driver of viability.**

The cost can also be measured in terms of human capital: financial institutions are now far less competitive at attracting talents, as illustrated below.

<u>Finance, not the employer of choice anymore</u>



[2] Source: Axiom AI controversies database

Clients are also more focused on bank's conduct and culture. Highly publicized cases on money laundering, tax fraud and others, have put pressure on bank's management to show they understand and manage culture risk.

It is fair to say that supervisors, regulators, and governments have dramatically increased scrutiny of culture at financial institutions.

However, an information problem remains. We do not have access to the quality of information that supervisors or bank managers can. Financial institutions' annual reports are filled with plain descriptions of "company culture". They all strive to focus on "client satisfaction", "responsibility" or "compliance culture". How can this be genuinely useful to us? How can we assess the effectiveness of the changes that managers are trying to implement in the firm and the extent of the remaining culture risk?

Our firm belief is that a financial institution's culture can only change very slowly. There are important items to check, in terms of the way the company is managed, but this is best addressed when looking at the governance of the company. Ultimately, the best indicator of a company's culture, is simply the short-term past: what has happened over the past few years and what does it tell us about the firm. What does it tell us about the top management, about the risk policies, about the expertise and training of the staff, about the quality of the control over offshore subsidiaries, etc. Because if something "is rotten in the kingdom of Denmark", it is unlikely to improve overnight, and even short-term changes could leave undisclosed skeletons in the closet. Even when a dramatic event, such as large money laundering allegations lead to a management overhaul, we do not think changing culture can be a one-off event. It is always a continuous and ongoing effort that needs to be integrated in the day-to-day business.

For financial institutions, a key component of conduct risk, is compliance risk. This is the risk that a company does not respect its legal obligations which can lead to direct or indirect financial loss. It includes such high-profile cases as tax fraud (for clients or for the company itself), money laundering, sanctions breach, etc.

Our approach to this risk involves three steps:

1. We identify the main sources of risk, based on previous cases, ongoing investigations, or prospective analysis.
2. We analyse the legal environment, what it means in terms of financial risk, and the internal policies of the relevant institutions.
3. Based on previous cases, on exposures, on financial publications, *etc*., we try to assess the risk that each institution is facing. No complacency is possible: we are aware that this can range from very benign cases to outright bankruptcy.

All these elements are compiled in our controversies database. Examples of important compliance matters that are in this database include:

1. Correspondent banking AML risk.
2. General AML risk.
3. Swiss-US tax fraud.
4. Dividend tax fraud.
5. FX market manipulation.

6. FHFA Fraud.
7. DOJ RMBS litigation.
8. OFAC sanctions breach.
9. Libor manipulation.

AML provides an example of the information which is accessible to portfolio managers if they want to understand the AML risk they are taking when investing in a specific financial institution:

10. Selected summaries of rules applicable in the main jurisdictions with sanctions guidelines.
11. NGO databases with exhaustive data on sample cases such as the Laundromat or the Troika allegations with bank-by-bank exposure.
12. Official (BIS, FATF, GFI, EC) ranking of jurisdictions on AML.
13. Market share analysis in high-risk jurisdictions.
14. When available, markets statistics on payment flows in high-risk jurisdictions.
15. Bank by bank analysis of exposures in high-risk jurisdictions.
16. Detailed case study of a sample of past high-profile cases as well as historical sanction data.
17. Ongoing cases.

Rather than using this data to calculate a “risk score” or a rating, which we believe is an artificial approach that does not adequately reflect the complexity embedded in such topics, we make all this information available to portfolio managers and the ESG and investment committees so that it can be used in investment decisions, in the same way financial information is used.

When a specific high-profile case with potentially severe financial consequences is revealed (such as Danske Bank in 2019) this is discussed extensively by the investment team.

2. Social controversies

No matter how important compliance failures can be, it is our belief that the mis selling of financial products (broadly defined) is the largest social risk that financial institutions are facing. Mis selling does not have a single source: indeed, it can result from an inappropriate culture (aggressive sales strategy, short term incentives for the staff), legal errors (misunderstanding of usury laws, for example) or even management integrity. In the UK, one single case, the inappropriate sale of payment protection insurance (or PPI, an insurance product to enable repayment of a credit if the borrower dies), led to a combined cost of more than 42bn£ for the banking sector.

It is more difficult to make an ex-ante assessment of this type of risk as it requires a very thorough analysis of the products (and the actual contract), of the case law, and of possible legal issues that have not yet been taken to court. Our approach relies on a two-step strategy:

1. Careful monitoring of the news, to identify as quickly as possible new areas of risk.
2. Legal and financial analysis of the exposure each bank is facing.

As for compliance risk, we do not try to estimate a risk score or a risk grade, but rather provide the portfolio managers and the ESG and investment committees with up-to-date information of all ongoing cases. We also keep historical data on past cases as they somehow provide information on the quality of each institution's internal processes and guide to future risk.

Examples of current major mis selling risks in the EU include:

1. Spanish credit card revolver loans.
2. Spanish mortgage loans indexation clauses
3. Polish FX mortgage loans.
4. Greek ATM fees.
5. Irish tracker mortgage loans.

An example of detailed analysis is the analysis of index clauses in Spanish mortgage floors, where the portfolio managers will have access to:

1. The background of the case (market size, description of the issue).
2. The main legal facts (important court decisions, key legal questions that remain unsolved).
3. The main sources of uncertainty to calculate the financial impact (claims rate, extent of retroactivity, etc.)
4. Range of estimates for the possible financial loss, for a selected sample of institutions.

Bank	IRPH exposure (bn€), 4Q 2019	Low estimate	High estimate	Low estimate%	High estimate %	% mortgage book	20y retroactivity - IRPH 1999	1999-2019 impact	2/27/2020 New Exposure disclosure
Bank 1	6700	1400	2800	20.9 %	41.8%	7.0%	14,839	2555	
Bank 2	4000	700	1500	17.5 %	37.5%	7.0%	9,208	1585	
Bank 3	3100	700	1500	22.6%	48.4%	4.0%	6,446	1100	
Bank 4	1300	300	600	23.1%	46.2%	2.0%	3,683	634	2900
Bank 5	800	200	400	25.0%	50.0%	2.0%	1,729	298	

3. Environmental controversies

Environmental controversies in the financial sector are today quite rare, but the expectation is for these to increase over time. They will arise as supervisors, regulators, NGOs, investors, and consumers put pressure on financial institutions for a better and more transparent integration of climate change considerations.

The expectation is that controversies on environmental issues will be mainly focused on climate or biodiversity issues. Among the reasons for the potential controversies, we find:

i. Reputational controversies due to:
   - Failure to meet environmental targets or commitments. For those institutions that have joined international initiatives such as the different Net Zero alliances (i.e. banks, asset owners, asset managers) as well as the Science Based targets Initiative. We have also seen recent investor activism looking for more binding commitments by filing shareholder resolutions on decarbonization targets[3].
   - Involvement in the financing, investment, underwriting, or reinsurance of projects or companies that are deemed to have a negative environmental impact. In the case of climate change, this is particularly critical for financial institutions that have signed up the aforementioned initiatives or that have set decarbonization commitments as latest research shows that in a Net Zero pathway there is no room for new oil and gas fields for development, new coal mines or extension and no new unabated coal power plants from 2021 onwards[4].
   - Lack of board members with relevant experience in sustainable finance. Although this is something that has only been seen so far in the corporate sphere, this trend will quickly move to the financial sector.

ii. Legal controversies due to the mis selling of products. In this case, the mis sell is explained by a mismatch between the environmental impact claims of a financial product or strategy (e.g. # tonnes of CO_2 avoided) and its real measurable impact. Controversies on this aspect are extremely rare today but the malpractice is exist. Their materialization are just matter of time. The results of the few legal cases open today will leave the door open for a myriad of new cases.

[3] See for example of the case of HSBC, which has to put forward its own resolution on decarbonization targets at the AGM after a coalition of 15 investors with $2.4tn in AuM filed a resolution for HSBC's May AGM calling for the bank to curtail its financing of fossil fuels.

[4] https://www.iea.org/reports/net-zero-by-2050