ARTICLE

WHY TURNER GOT IT WRONG

Specialising in:
- Governance
- Risk Management
- Due Diligence

Chapter 1 of the Turner Review devotes itself to the question 'What went wrong?' The answer is critical to the identification of the changes that need to be made within the banking industry to prevent future crises of similar or greater magnitude. Worryingly the answers Turner provides (under the headings: The global story: macro trends meet financial innovation; UK specific developments; Global finance without global government; and Fundamental theoretical issues), ignore the key causal factors of the credit crisis. As such Turner fell at the first hurdle. His recommendations need to be judged in that light.

The notion that UK banks such as HBOS and RBS collapsed because of severe and unforeseen changes in market conditions was also advanced by the former Chairmen and CEOs of those banks during a Treasury Select Committee hearing – another case study in missed opportunity. Andy Hornby and Lord Stevenson ex HBOS claimed at various points that the shrinkage of the wholesale funding market was the key causal factor whilst Sir Tom McKillop ex RBS pointed to the way in which the 'origin and distribute' model transpired unpredictably, to destabilise the market.

The contention that external factors conspired to cause the ruination of banks ignores the fact that other banks survived the crisis, some in very good shape. The banks that failed made choices about the manner in which they conducted their business. The FSA also made choices about the manner in which those banks were allowed to run their affairs. Those choices were flawed.

As they say in the aviation industry – *'ice on the wings never killed anybody, it's the decision to fly with ice on the wings that kills people'*. Understanding why and on what basis those flawed choices were made is vital to identifying a key causal factor of the banking crisis.

CHOICE OF LEADERS

To the man on the street the elite group of individuals that run banks appear to be members of an old boy network. They seem to select in their own image as if the most vital question at recruitment is not 'will this person challenge the status quo? Is he the best we can get?', but 'what sort of fellow is he? Do I like him? Will he fit?'. The result in many banks has been a chummy consensus that provides fertile ground for error.

Let's take the example of Sir Tom McKillop the former Chairman of RBS. He is undoubtedly a bright man with a proven track record in business but in a board recruitment process founded on the principle of meritocracy should he have been allowed to sit at the helm of a bank board? When asked by the Treasury Select Committee what qualified him to be the Chairman of a bank he answered: I am numerate; I was on the board of Lloyds TSB for 5 years (why?); I have extensive experience of cross border transactions; and I was formerly the CEO of a pharmaceutical company. All valuable experience, but to be the Chairman of a bank engaged in complex investment banking arrangements? Arguably not. The collapse of RBS supports the point.

Similarly how can we explain the appointment to the board of HBOS of Charles Dunstone the founder of Carphone Warehouse? Mr Dunstone is undoubtedly a talented retailer of mobile telephony but what qualified him to fulfil the role of Chairman of the Retail Risk Control Committee of a large bank? What relevant formal professional qualifications did Dunstone have? What technical competence did he possess in banking or credit risk management that qualified him to chair a vital governance committee?

In his now famous memo, the former Head of Regulatory Risk at HBOS Paul Moore claimed that Dunstone and the Chief Executive, Andy Hornby were good friends and that Dunstone said to him and colleagues words to the effect that he had no real idea how to be Chairman of the Retail Risk Control Committee. No surprises there then.

How on earth could this have happened? How can it have been allowed to happen? What do these choices tell us about the culture of HBOS? What was HBOS, through the appointment of Charles Dunstone to the Chair of a Risk Committee, communicating internally to its people about its attitude towards risk management relative to other considerations such as the pursuit of profit?

The character of an organisation often comes down to the behaviour of its leaders who encourage the behaviour they exhibit and thus tolerate. This is not rocket science. If banks are to avoid the same mistakes again they must define how they want their people to behave. That behaviour has to be modelled, taught, expected, measured and rewarded. There is no recognition of this in the Turner Review.

SACKING AND GAGGING A WHISTLEBLOWER

Paul Moore, the former Head of Regulatory Risk at HBOS raised a series of concerns about the way in which the bank was conducting its business. In summary he claims to have raised the following points:

- The bank was going 'too fast'
- The bank had a cultural indisposition to challenge
- The bank's sales culture was significantly out of balance with its systems and controls

– The bank was a serious risk to financial stability

Moore was fired, paid off and silenced. The bank then commissioned an 'independent review' by its auditors and replaced Moore with a new Group Risk Director who Moore claimed *'had never carried out a role as a risk manager of any type before'.* There are three important questions of note. Firstly, why if the bank was genuinely concerned to interrogate the issues raised by Moore, was he sacked? Secondly, why, if the bank was determined to get to the bottom of the points Moore raised (and if it were determined to demonstrate that it was committed to doing so), did it not appoint a totally independent third party to conduct the review? Third, why if the bank was as serious about managing risk as it was about making money did it, despite the red flags raised by Moore, appoint as his replacement somebody who had never fulfilled a risk management function before?

What message did these choices send internally about the bank's attitude to risk management? Is it possible that as a consequence employees who thought that something didn't 'smell right' decided that their interests might be better served by 'keeping their heads down' for fear that if they stuck their heads above the parapet they might come under fire?

The point here, missed by Turner is that if through the choices they make an organisation's leaders don't model the right behaviour it is highly unlikely that anyone else will exhibit those behaviours.

CULTURE

Space does not allow for an extensive discourse on all of the management failings that resulted in the current crisis, but more generally anybody within a risk management function in a bank will know that the characteristics that are championed within their organisations are anathema to quality high level decision making. Characteristics, displayed by aggressive, dominant, deal making egotists are precisely the characteristics that are 'selected out' in industries that have a more sophisticated approach to risk management, such as aviation.

In an ultra competitive market such as investment banking, those characters are needed of course but it is vital that they are properly counterweighted by governance architecture that empowers and resources risk management functions overseen by leaders that understand that there should be no trade off between values and performance.

The effects of the management failings within banks are being widely felt and will last for many years to come. If ever there were any doubt that society is a stakeholder in the banking industry the current crisis proves it. As such it is incumbent upon banks to question the values upon which they have conducted their business historically and upon the banking regulators to interrogate with vigour the reasons why the culture, of certain banks was so deeply flawed. The well intentioned Turner Review devotes only one page to the subject of 'Risk Management and Governance: firm skills, processes and structures' and refers instead to the Walker Review on bank governance due to report in October 2009. The concern is that these issues have effectively been kicked into the 'long grass'. The failure of Turner to devote more attention to them represents a lost opportunity that will help not to avert, but to lay the groundwork for future financial crises.

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