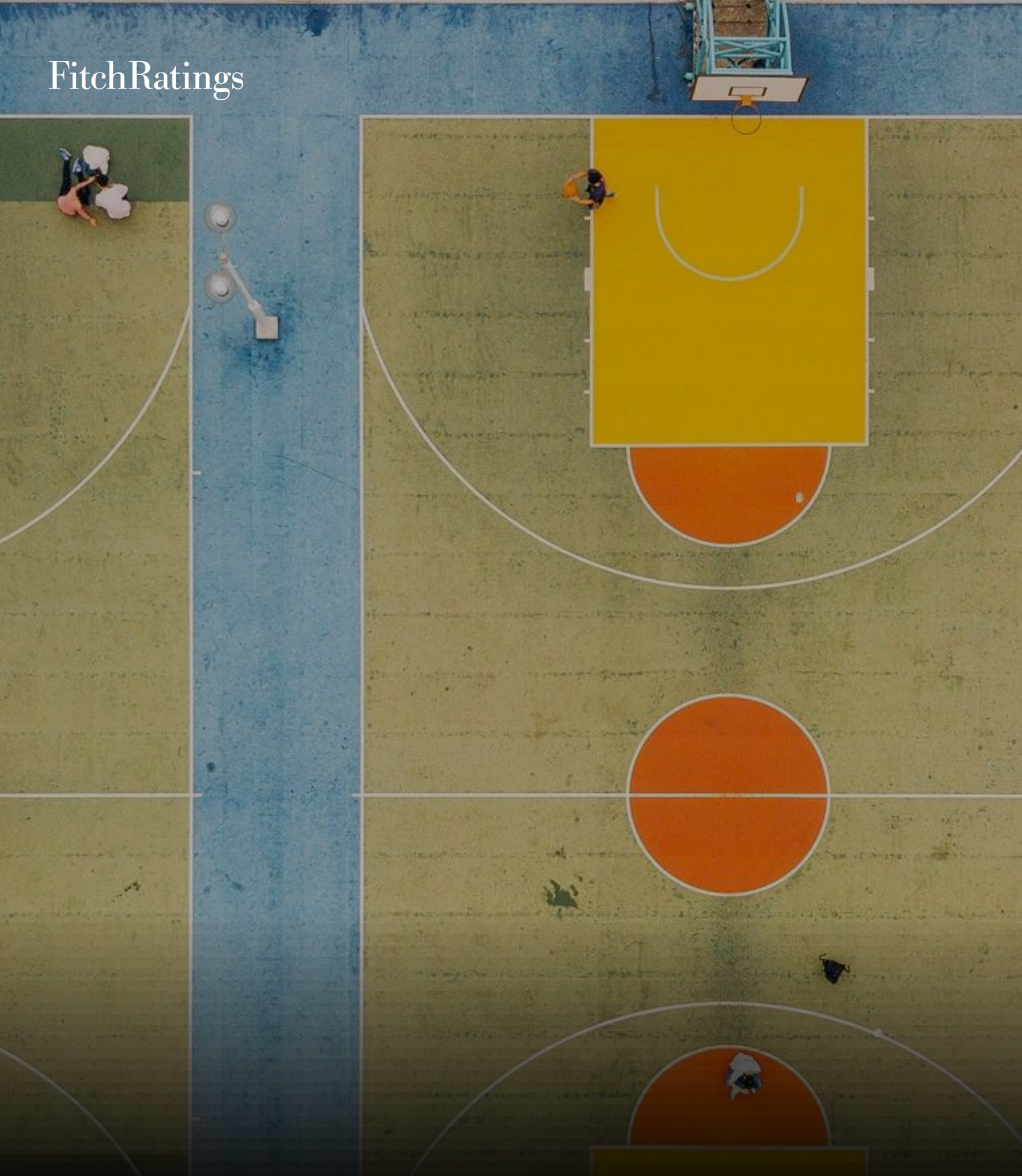


Governance Risk for Banks

Drawing on Experience and External Expertise to Assess Financial Crime Risk

Governance Risk for Banks

Drawing on Experience and External Expertise to Assess Financial Crime Risk

This report refers to Sigma Ratings, a New York-based data and analytics firm in which Fitch Group owns a minority stake. Sigma uses artificial intelligence and machine learning to distil publicly available data into structured, organised, non-financial risk typologies and event types to enhance client oversight for financial crime.

Fitch used Sigma as a source for ex-post 'lessons learned' reviews as its scanned data is categorised and stored in one place. We may consider using Sigma's data and other external expertise going forward to spot trends.

Rating Relevance of Non-Financial Risks

Failures in managing non-financial risks such as governance and financial crime risks often result in fines, penalties and remediation costs. This report assesses an entity's vulnerability to these non-financial risks, how early we should act on signals, and how much weight to attribute to individual external data points in evolving governance situations.

In many emerging markets, our operating environment assessments capture heightened jurisdictional governance and financial crime risks. In developed markets, jurisdictional risks tend to be lower, and idiosyncratic governance and financial crime risks, which can be more difficult to spot in complex organisations, have tended to be less material to ratings than other considerations.

Fitch Ratings believes that continued focus on qualitative governance rating considerations remains important in a forward-looking rating framework. The impact of misconduct and financial crime already matters beyond just the initial dollar amount of a fine for a bank. Industry experts have indicated that remediation costs are 12x greater than the amount of the initial fine.

Likely to Become More Ratings Relevant

Public authorities, consumers and ESG-aware investors are increasingly conscious of the social impact of the institutions they do business with and less tolerant of transgressions. Consequently, governance and financial crime risks – along with associated financial penalties and indirect business costs - are likely to become more ratings-relevant.

Conclusions from Analysis of Case Studies

- Fitch's analysis of three recent high-profile case studies of developed markets banks, using Sigma data, shows that we are broadly capturing the risks.
- The timing and magnitude of a potential governance-related rating actions depend on Fitch's view of trends leading up to an event and an entity's capacity to remediate. Early warning signals will not necessarily result in rating actions, but a pattern (or aggregation) of relevant news-flow and data makes a potential rating action more likely.
- Provided there is sufficient public news-flow and data, technology and algorithms can facilitate data screening and thereby assist in evaluating unfolding governance risk in a rated entity.
- Most of the time governance is a low-risk, low-influence rating factor for banks in developed markets. But sometimes it can be critical, and increasing intolerance of misdemeanours means its importance is likely to increase.
- In many emerging markets, jurisdictional risks already weigh on ratings.

Related Criteria

Bank Rating Criteria (February 2020)

Analysts – Fitch Ratings

Sabine Bauer, Fitch Ratings
Group Credit Officer FI EMEA
+46 81215 1369
sabine.bauer@fitchratings.com

James Longsdon, Fitch Ratings
Global Head of Bank Ratings
+44 20 3530 1076
james.longsdon@fitchratings.com

Analysts - sigma

Gabrielle Haddad, Sigma Ratings
Founder, COO
+1 212 575-0233
gabrielle@sigmaratings.com

Philip Wittmann, Sigma Ratings
Director, Head of Client Success
+1 212 575-0233
phil@sigmaratings.com

Fitch's Governance Assessment

The traditional governance elements such as transparency, ownership and organisational structure are primarily captured in Fitch's Company Profile and Management & Strategy assessments. We aim to identify structural weaknesses that expose entities to governance events and potentially higher credit risk.

Fitch also evaluates banks' exposure to the wide range of regulatory, legal and compliance risks through an assessment of the business lines and jurisdictions they operate in. The Operating Environment and Risk Appetite assessments are also key elements in our analysis. Strong controls might mitigate operational risks, including financial crime and misconduct risks.

Furthermore, we consider drivers for outperformance relative to peers as this is often linked to higher risk appetite, but it could also be an early warning sign for governance weaknesses.

Relevant Rating Criteria Factors for Fitch's Banks Analysis

- Operating environment
- Company profile
- Management and strategy
- Risk appetite

Fitch considers public and non-public information from a broad range of sources in forming our rating assessment. Interaction with issuers and market participants is important as we seek to identify misconduct risk or substantiate allegations of misconduct.

Fitch's ratings do not capture fraud (see Event Risk section on p. 95 of Fitch's Bank Ratings Criteria) and other factors that are externally or internally triggered (e.g. a change in law or a change in strategy, respectively). However, where we have indications of heightened fraud risk, e.g. if a company failed to obtain a clean audit or where material related party lending raises concerns, we would factor that into our ratings.

The rating impact of a negative governance event or an entity's vulnerability to it is also determined by the rating level of the issuer, its materiality and ratings headroom. A governance event might not have a rating impact if the issuer's rating is already low due to other rating factors, but weak governance would be captured in Fitch's Environmental, Social and Governance Relevance Scores (ESG.RS) which are observations on rating decisions and highlight potential weaknesses or strengths in any of these factors.

Financial Crime Risk

The key elements of financial crime risk usually contain money laundering, providing financing to sanctioned entities, terrorist financing or other illicit activity.

Understanding the potential risk associated with these activities begins with understanding the inherent risk of the entity, such as where it operates, what products and services it offers and who is associated with the entity (e.g. customers, shareholders, management). This is typically covered under our Operating Environment, Company Profile and Risk Appetite assessments.

This inherent risk must be considered alongside what the entity is doing to combat it. These factors include governance structure (considered under Management & Strategy), systems and controls (also considered under Risk Appetite) to be able to understand the deficiencies more deeply, and whether an entity has remediated possible issues or simply continues to allow bad behavior to continue.

Timeline Analysis

Fitch reviewed three banks in developed markets whose credit ratings or Outlooks were ultimately impacted as a result of governance and financial crime risk. We manually reviewed the three banks in Sigma's web-based platform for historical event details. With the benefit of hindsight, we considered how Fitch might be able to make use of the data in a platform such as Sigma's.

Moving the Trigger Events Forward

Significant regulatory announcements on misconduct, which often conclude with a fine, create new facts and can serve as rating trigger events. This is because they are conclusive and based on new information. They prompt the re-assessment of non-financial risks as well as an assessment of the financial impact after the event.

The Sigma terminal gathers potential early-trigger events and news-flow into one convenient location. However, their rating-relevance depends on Fitch's interpretation and judgement to differentiate less material noise and remediable shortcomings from events that can genuinely and materially affect an issuer's creditworthiness and rating.

Fitch is keen to reflect trigger events in our ratings as early as possible. An early notification on a regulatory inquiry or adverse media story could serve as strong evidence of concern on the part of the authorities or of an underlying problem. It would be actionable if we could overlay it with an informed view of the allegations' potential merits.

Analysts may be aware of investigations or allegations, but they may be less familiar with the technicalities of a specific allegation or investigation, or they may perceive potential issues as isolated and individual events instead of a series of events pointing towards a more comprehensive trend. Specialist information aggregators and risk assessors like Sigma might only partially solve this in a ratings context, but using such data systematically could place individual events into perspective.

That said, there may be cases where allegations, regulatory or legal action are motivated by other considerations and that what appears to be a trend was coincidence. There are also likely to be jurisdictions where weak regulatory and legal frameworks and different media priorities result in under-reporting publicly of governance and financial crime flags.

Furthermore, some automatically generated warning indicators may lead to more 'false positives' than others, depending on the way they are configured. For example, Sigma's scanning for, and classification of, politically exposed persons (PEPs) is intentionally very wide (for example including individuals who have worked previously at supervisors or in commercial banks with state involvement).

As a result, it flags individuals that Fitch does not believe represent a governance risk from the perspective of being vulnerable to undue government influence. Sigma's PEP classification is likely to be of more use in a ratings framework in jurisdictions with a weaker regulatory framework and corresponding degree of oversight.

Similar Patterns

A key lesson learnt is that initial investigations usually extend into other areas and they often reveal further weaknesses which require continuous attention.

Furthermore, initial allegations, once followed up by the authorities, will usually lead to fines and findings. Fines have so far not threatened large banks' viability. Large banks usually face challenges from reputational factors, and longer-term profit pressure from strategy adjustments, funding cost risk-premiums and remediation. Other indirect and less measurable elements include potential damage to the franchises, distractions for management, and fluctuations in the stock or debt prices.

The urgency to change or overcome control deficiencies has been addressed by regulators appointing teams that report on the banks' remediation progress, as was the case at e.g. HSBC Holdings plc (A+/RON/a+) and Standard Chartered plc (A/RON/a). These banks, like others, were subjected by the authorities to multi-year compliance monitoring, which highlights the importance of robust remediation and suggests limited tolerance for future governance missteps.

A medium-sized or small bank may materially suffer from a fine and potentially "jump to default" if a banking licence is withdrawn, as was the case for Banca Privada d'Andorra in March 2015.

Three Case Studies

The three recent cases for which we provide a more detailed review in this report all have slightly different elements to them and illustrate the different ways in which the use of companies like Sigma as an early warning tool can be valuable for credit analysis.

The Case of Banca Privada d'Andorra:

In March 2015, the US Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) named Banca Privada d'Andorra, whose IDR Fitch had rated 'BB+' at the time, as a 'foreign financial institution of primary money laundering concern', and proposed measures against the bank, cutting it off from the US financial system. The bank very quickly suffered severe difficulties in its basic functioning after FinCEN's allegations and Fitch downgraded it to Restricted Default eight days after the allegations.

They are:

- Commonwealth Bank of Australia (A+/RON): AML issues domestically through ATM deposits; a series of technology events pointed to operational risks early.
- Wells Fargo & Company (A+/RON): sales practices and internal fraud; above-peers profitability, moderate fine but regulatory asset cap; remediation has taken time.
- Danske Bank (A/RON): AML failures in its Baltic operations; home and host regulators involved.

The ultimate impacts from these scandals on banks' reputation and financial profile are always hard to quantify at the time when the first signs of the allegations come to light. This uncertainty was initially reflected in Fitch's ratings on these entities with Negative Outlooks.

As Fitch concluded that its view of risk controls for Wells Fargo was too high, we lowered our ratings in October 2017 ahead of being aware of the full financial impact. All three entities remain rated in the 'A' category, and their IDRs remain on Negative Outlook, to different degrees now also due to headwinds stemming from the coronavirus pandemic.

Timeline 1: Commonwealth Bank Australia

Between 2012 and 2015, CBA (A+/RON) failed to report more than 53,000 suspicious transactions to authorities on time. Australia's financial crime authorities (AUSTRAC) commenced court proceedings against CBA in August 2017. They found that CBA's ATMs allowed for large anonymous deposits to CBA accounts. CBA has linked the failure to a coding error in its computer systems and a software error in the bank's smart ATMs. In the same month, Australia's prudential regulator (APRA) launched a prudential inquiry into CBA's broader governance, accountability and culture.

Fitch first commented on Australia's banks' potential misconduct issues on 7 April 2016. The first time we commented specifically on AUSTRAC's legal action against CBA was on 18 August 2017, which was followed by a comment on the potential reputational challenges to the system or individual entities from the Royal Commission on 30 November 2017.

Two highly publicised key regulatory events in this case, to which Fitch's actions were linked, also appear on Sigma's terminal. They occurred on 3 August 2017, when APRA started its inquiry, and on 1 May 2018 when it concluded that CBA was misconducting and had contravened the AML/CTF act in multiple occasions.

Fitch revised CBA's Outlook to Negative on 6 May 2018 adjusted our view of the bank's risk appetite as well as management and strategy when the final prudential report revealed that CBA's shortcomings were more widespread than we had previously incorporated into our assessment. Fitch identified findings of systemic failure by the August 2017 inquiry as a downgrade sensitivity in February 2018. However, we held on to the assumption that the incidents were isolated.

While inquiries into the sector were ongoing, Fitch affirmed CBA's IDR at AA-/RON in February 2019 on the expectation that the bank will maintain its strong company and financial profiles. The Negative Outlook reflected ongoing remediation challenges.

Remediation remained on track and Fitch affirmed CBA's IDR again in January 2020 with a Negative Outlook as the bank still had to embed most of these changes in the organisation. Fitch's ESG.RS score of 5 for CBA's governance structure highlighted shortcomings in the bank's oversight of operational and compliance risks. CBA also had an ESG.RS of 4 for customer welfare risk, reflecting conduct and culture issues.

Fitch downgraded CBA in April 2020 on coronavirus risks and kept the Outlook Negative. We said that CBA's franchise did not appear to have been impaired by its remediation of conduct-related issues, which was a key reason for the Negative Outlook at the previous rating level.

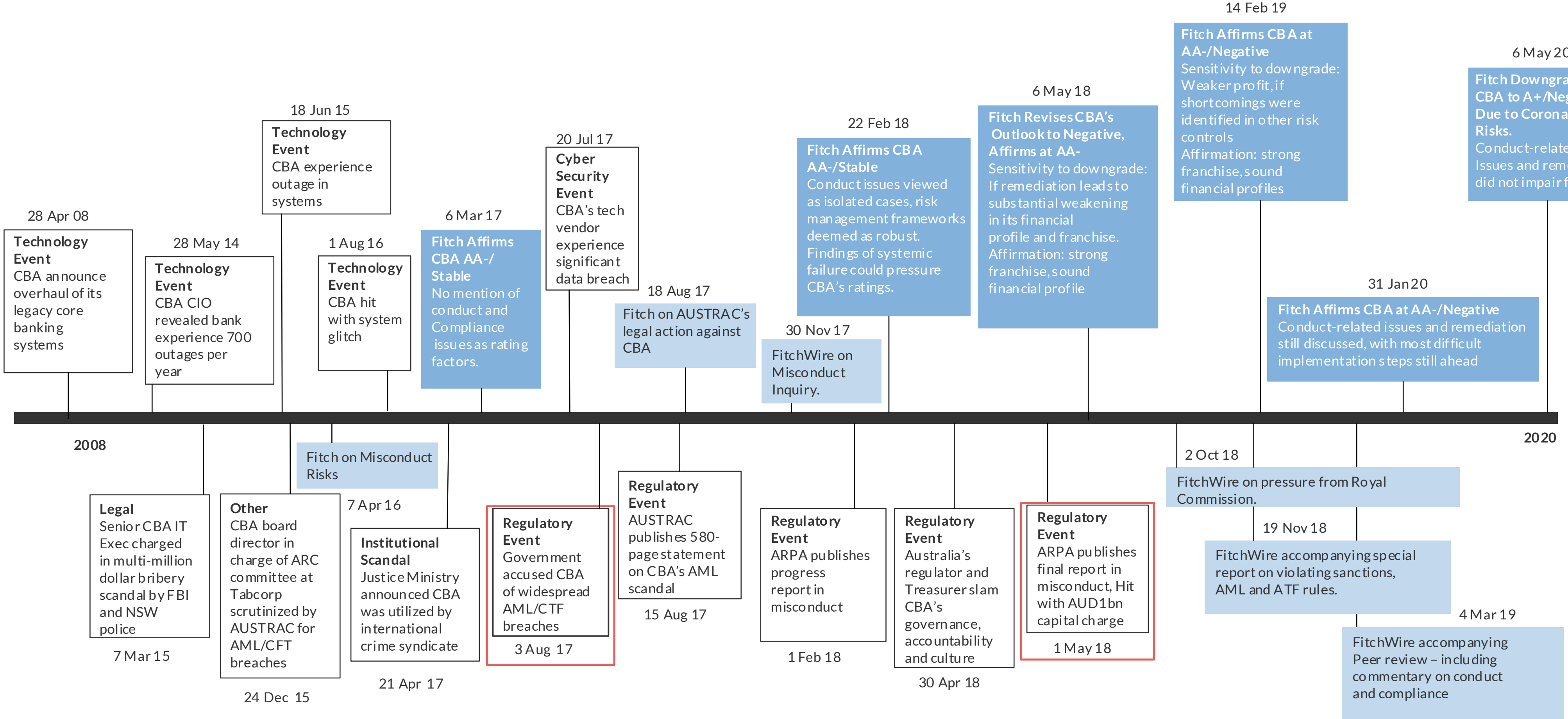
Sigma's event log shows an extensive history of technological issues for CBA, which might have already pointed towards heightened operational risks. The technology events in 2014-2016 shown in the below timeline appear to be of limited significance in themselves, but they could have been leads for further investigation.

That said, CBA has been generally accepted as a market leader in technology implementation, and, while similar outages were occurring across most banks in the system, CBA gets reported on more frequently than others regardless of severity.

What conclusions could have been drawn from Sigma data in hindsight?

- The benefit of analysing events/incidents holistically rather than as isolated events, e.g. assess if the technology events are indicative of broader operational issues.
- Consider whether the buildup of events (eg technology) is or is not consistent with Fitch's expectations on operational and governance controls.
- The involvement of various authorities, including the prudential regulator, points towards the depth and significance of the issues and limited future tolerance.

Timeline for Commonwealth Bank of Australia



Source: Fitch Ratings, Sigma Ratings

Timeline 2: Wells Fargo & Company

Wells Fargo & Company (WFC, A+/RON) was fined USD185 million in September 2016 for creating as many as two million fictitious accounts. The root cause was top-down pressure from executive management for branch employees to cross-sell as many accounts as possible. For years, WFC was touted as a consumer bank which outperformed competitors in consumer profitability due to record numbers of accounts per customer. As far back as 2013, there were media reports on the high-pressure culture at the bank and reports of abuse, which culminated in the City of Los Angeles filing a lawsuit against the bank for fraudulent practices.

Fitch had consistently highlighted WFC's above-average profitability as a key rating driver. In a highly competitive banking environment a bank's ability to consistently outperform peer performance metrics in the absence of any obvious unique competitive advantages, combined with turnover in community banking roles and media reports chronicling the aggressive culture of the bank, might have served as a red flag.

Fitch's downgrade of WFC's IDR to A+/Stable on 3 October 2017 reflected the view that WFC's earnings profile would be diminished from historical levels and that improved risk governance and controls will take longer than anticipated. While WFC has taken numerous steps to address the poor sales practices issues which drove the Outlook revision in October 2016, it has also since been revealed the bank identified governance and control weaknesses in other parts of the business, including the origination, servicing, and/or collection of indirect consumer auto loans.

Fitch views additional risk control and governance weaknesses, namely regarding the CPI policies, as outside of the agency's expectations, and supportive of the lower risk-appetite rating, which includes risk controls.

The Outlook revision in October 2016 reflected potential damage to the firm's franchise and earnings profile from regulatory actions. Fitch viewed the ensuing reputational damage, risk oversight failures, impact to its selling practices, and the resulting effect on earnings as much larger negative rating issues than the actual fine.

Fitch stated that, while this issue was not new, as it was first reported by the media in 2013 and the Los Angeles city attorney filed a suit in May 2015, the breadth of the issue was surprising and appeared to be a significant breakdown in what it had viewed as solid risk management infrastructure. This was captured in WFC's high ratings prior to the events (AA-/Stable, 5 October 2015). Fitch assumed that WFC's greater immunity to risk management failures, and lack of outsized legal charges that have plagued the bigger banks, came from its long-tenured senior management team and strong corporate risk culture.

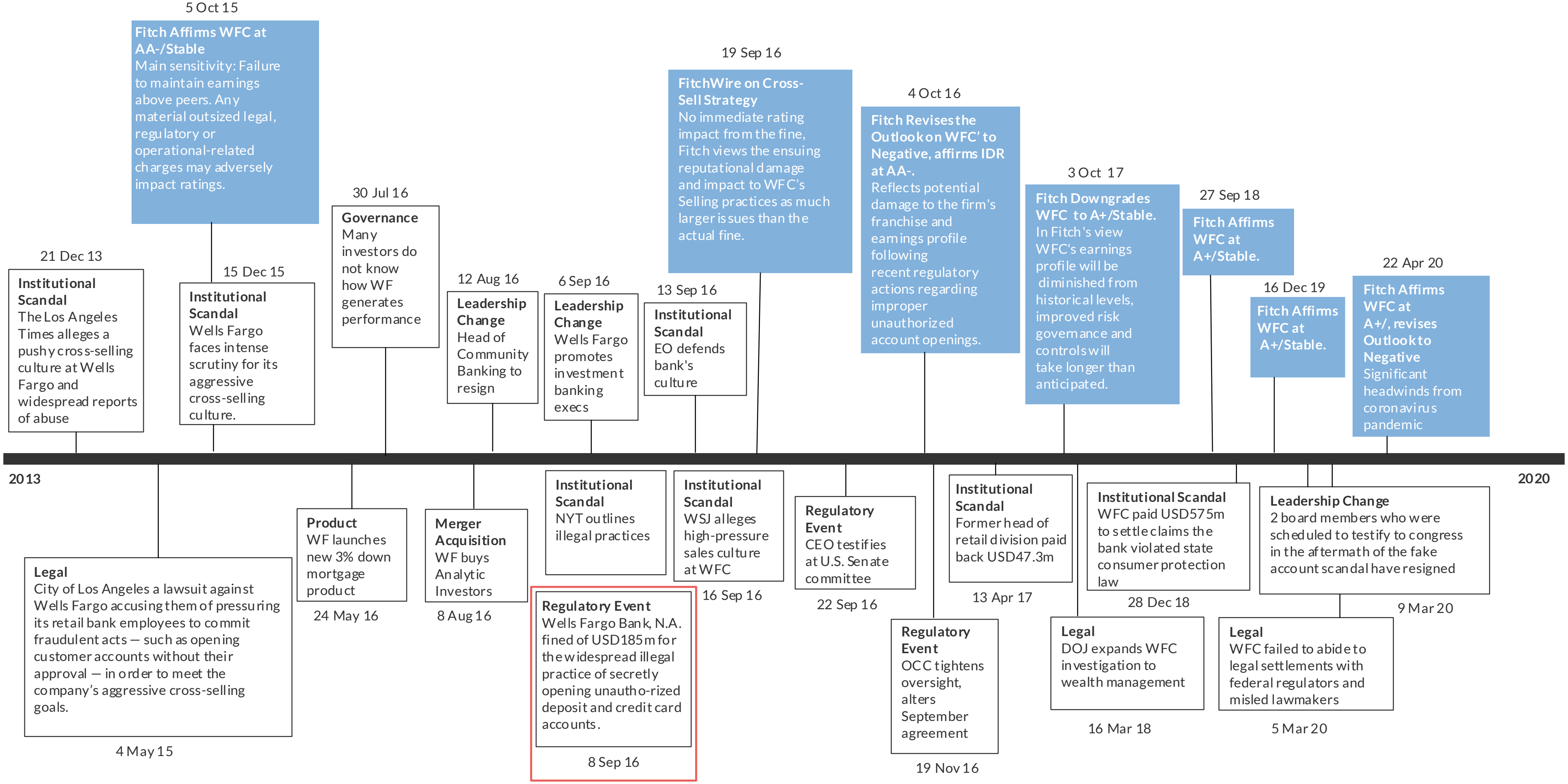
In Fitch's first commentary on the topic on 19 September 2016 Fitch also commented on the retirement of WFC's Community Banking business line in mid-July 2016, however, did not attribute this to prior reports around WFC's cross-selling culture.

Fitch maintains ESG.RS of 4 for both management and strategy and governance structure, which indicates that these factors are relevant to WFC's credit rating, but not currently a key rating driver.

What conclusions could have been drawn from Sigma data in hindsight?

- Analyse performance in light of the build-up of governance risk events and high turnover, and reference to cross-selling culture
- Consider potential broader implications of leadership change
- Oversight failures across businesses can be much larger issues than the actual fines

Timeline for Wells Fargo & Company



Source: Fitch Ratings, Sigma Ratings

Timeline 3: Danske Bank

The rating trigger event when Fitch revised the Outlook of Danske Bank (A/RON) to Negative was the bank's release of the findings from a law firm's investigations into Danske's Estonian operations, which were accompanied by statements by government officials which quantified a potential fine.

In March 2017, Sigma identified risk events suggesting issues associated with Danske Bank, and its Estonia Branch, that could have indicated a heightened vulnerability to a regulatory finding, while also being helpful in focusing investigations and analysis. Sigma identified adverse media exposure associated with the allegations and details of the scandal, recurring leadership changes, legal actions, and formal announcements of investigations and regulatory action.

Even so, Danske maintained rating headroom at the unchanged 'A' level. The key rating drivers all have mid-points of 'a', with the positive outliers of company profile, risk appetite and funding and liquidity at a+. Similarly, in the current environment with coronavirus-related economic shocks, Fitch affirmed the rating at 'A'.

The report on the non-resident portfolio of Danske's Estonian branch released on 19 September 2018 confirmed that there were serious deficiencies in the bank's control framework. However, a large part of the non-resident clients was not yet investigated and sanction screening was not yet complete. Fitch's rating sensitivity focused primarily on the financial consequences and the size of a potential fine. Non-financial factors including the potential negative consequences on the bank's franchise and management and strategy were also discussed.

The rating affirmation with Stable Outlook that preceded the rating trigger event by just six weeks positively highlighted the bank's strengthened risk appetite framework. We recognised that in recent years the bank had invested heavily in strengthening its corporate governance framework, including adding a substantial volume of staff dedicated to anti money laundering activity.

Fitch since affirmed and maintained the Negative Outlook on 2 July 2019 and on 19 June 2020, maintaining the previously identified sensitivities, which included a material fine. Fitch has maintained its '4' ESG.RS score for Governance Structure for Danske given that legal risk from a large fine remains elevated and drives the Negative Outlook but only together with the economic fallout from the coronavirus outbreak.

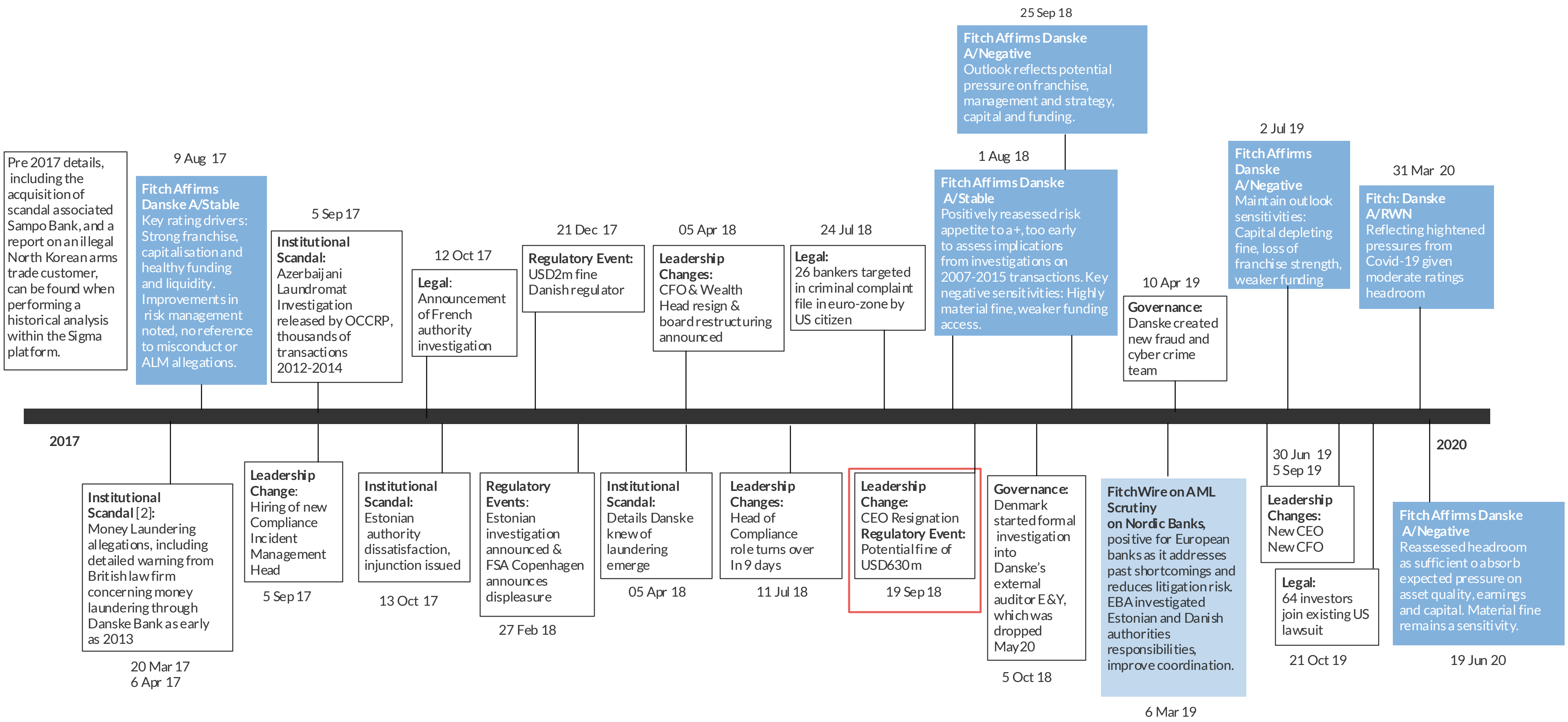
Sigma's risk indicators as of September 2020 continue to highlight risk flags at Danske Bank under Sigma's framework. This is indicated through risk flags for operating in high risk jurisdictions (trade relations with Russia, Bangladesh, China) as defined by Sigma's country risk model. Sigma also flags a number of Danske's directors as PEPs under its framework.

However, this is a product of the intentionally wide scope of Sigma's framework and Fitch does not consider them to be a source of governance risk. The platform also shows recent adverse media coverage related to its debt collection system and potential overcharging for investment products suggesting that Danske still has matters to address as it works on strengthening governance and oversight.

What conclusions could have been drawn from Sigma data in hindsight?

- Balance recent strengthening of corporate governance and controls with all legal, management and regulatory risk events
- Consider whether earlier risk events and lessons learned from other cases support the allegations' potential merits
- Consider improvements in risk framework and AML staffing in the context of risk events / trends shown on the timeline

Timeline for Danske Bank



Source: Fitch Ratings, Sigma Ratings

σ sigma

About Sigma Ratings

Fitch has engaged with Sigma and tested its terminal over the course of a five-month period. Its entity event log, which employs artificial intelligence and machine learning, scans categorises, and contextualises meaningful financial and non-financial risk events at entities and in jurisdictions. It has the capacity to be a useful information source when assessing non-financial risks as part of a rating process.

Sigma scans and analyses entities against data collected from more than 1,000 structured sources, and 30,000 news sources. Its technology assesses factors ranging from jurisdictional risk to personnel risk to associations risk. Sigma organises these into 12 non-financial risk indicators and 18 risk event types that are specific to financial crime and governance risk analysis.

The 12 risk indicators, primarily based on mapping static and (regularly) recurring data against entities, provide an instant insight into a specific type of risk that exists for an entity at any point in time.

The monitoring of entities is more specifically addressed by the Sigma technology that maps entity news and related data changes to the 18 events (see details below) that Sigma identified as relevant in the financial crime risk context, with tailored alerts allowing a user to stay on top of risk developments as they happen. The 18 events are driven by international best practice in financial crime compliance and common policies of financial institutions, and historically have been indicators for an increase in potential illicit activity (i.e. fines, or investigations) or organisational issues associated with remediation of illicit activity (i.e turnover in key leadership roles).

Sigma also assesses country risk. Sigma's country risk provides top line scores on over 260 countries and territories and sub-scores in the categories of financial crime, regulation, geopolitical and corruption risk. The country scoring (highest to lowest) and percentile rankings contain factors that Fitch also assesses as part of its bank operating environment analysis. Despite the overlaps, Sigma's focus on non-credit country risk factors may provide additional information.

The Sigma terminal does not create news in itself. It collects and condenses public news and filings. In the event there is no news, Sigma will still provide updates of structured data changes (outside of news) such as change in corporate ownership, increased exposure to certain jurisdictions, etc. that suggest a possible increased vulnerability of a company to non-financial risk.

Governance and Credit Related Sigma Events

Each event is dated and presented in chronological order, and also colour coded to indicate negative/neutral and positive direction. Out of the 18 risk events Fitch believes that there are four categories that are most relevant to credit in banks:

- **Regulatory events:** an event that indicates a regulator has done something to an entity, e.g. fine, conviction.
- **Institutional scandals:** adverse events that do not involve a regulator or government.
- **Governance:** a major change in procedures or lapse of effectiveness of governance. Creation or dismantling of a committee, allegations of fraud, corruption, personal dealings, conflicts of interest, poor accounting practices, failure of audit.
- **Legal:** any legal action that is not a regulatory event.

The Sigma Terminal

- Provides relevant structured and unstructured data in one place
- Offers country risk assessments that specialise in financial crime risk
- Entity specific information contains Sigma's risk indicators and a news flow categorised by risk event

Sources:

- Public data
- Regulators, authorities, law enforcement agencies, companies, trade records
- Corporate registries, offshore leaks database, PEP and sanction lists
- News media

Many of these events might be highly publicised and covered through regular surveillance. The event log might however be useful for monitoring global entities for which it is more difficult to keep track of these events given the multiple jurisdictions they are active in. Sigma's technology picks up English language news sources globally.

Timely notifications about leadership and shareholder changes could also be among the more relevant signals if they are specifically linked to financial crime and misconduct themes. Other Sigma-relevant events include product changes, location changes, operational changes, M&A, subsidiary changes, brand changes, credit score/rating change, cyber security and technology events, and divestments. If an entity experiences many of those, taking them all together, they could indicate heightened vulnerabilities and we could assess if our views still hold.

The event list is currently chronological, and grouping and filtering according to certain types of trigger events are future enhancements that Sigma plans to offer