The right and proper financial consequences to (mis)conduct

By Christopher Stears | November 2013

The right and proper 'financial' consequences to [mis]conduct is (and will continue to be) a subject on which we will encounter polarised opinion.

The 'huge' fines being meted out by law enforcement agencies and regulators across the banking sector are 'material' (by most stakeholder's reckoning). Prudential regulators are certainly alive to these costs. Take for instance, the impact of conduct cost expenses on UBS's bottom line – the bank reported on Tuesday that the Swiss Financial Market Supervisory Authority was forcing it to hold more capital because of "known or unknown litigation, compliance and other operational risk matters" (see the article by Jill Treanor in The Guardian entitled, "UBS forced to hold more capital amid currency probe" (29 October 2013). And this was, we understand, in spite of the bank increasing its headline Pillar I capital by reducing its risk weights assets over the recent past. But what of particular note is the Swiss authorities' concern over the 'unknown' and well as the known risk factors. The capital adequacy consequences reflected a judgement-based, forward-looking evaluation of the bank's risk profile.

In any event, the capital consequences of legal risk can no longer be ignored. Hitherto, it may have been difficult to make the business case for a complete rethink of banks' conduct risk management systems. Now, the effective management of legal risk is not simply a conduct matter, but has taken on prudential significance. Banks' will now have to not only exhibit a 'changed culture' but also demonstrate robust operational risk management systems, designed specifically to identify, analyse, mitigate and feedback on conduct risks. This is where we see tangible value in the data being collated by the LSE Conduct Costs Project – data that must surely be at the fingertips of legal risk management personnel.

Equally apposite is the debate on the unintended consequences of regulatory action for misconduct (i.e. the effect on stakeholders beyond the need to punish culpability and deter misconduct generally). Indeed, the culpability issues are just what appear to be preventing a settlement between JP Morgan and US authorities concerning mortgage securities.

JP Morgan argue that when they acquired Washington Mutual (WaMu) in September 2008, they did not assume responsibility for the bank's past misconduct: in relation to mortgage securities or, perhaps, at all. As a result, JP Morgan argue, any fine levied against them in respect of WaMu misconduct should be indemnified by the US federal compensation scheme operator, FDIC, as WaMu's receiver. Thus, (as Francesco Guerrera (the Wall Street Journal Financial Editor) reported on October 27, 2013), this leads to the somewhat perverse situation of "…forc[ing] one federal agency to fund part of a landmark settlement negotiated by another agency." The outcome, at the time of writing is unclear. Nevertheless, the case raises questions concerning liability for legacy misconduct and the policies of enforcement being pursued by the authorities.

Should the bank in fact suffer the financial consequences of so-called pre acquisition or legacy misconduct? Should enforcement policy not require that, in the absence of a clear and unambiguous assumption of responsibly, there exists direct culpability in respect of the misconduct?

I am reminded of the reports of the existence of a 'comfort letter', apparently issued by the US regulators at the time of the acquisitions by JP Morgan, providing an assurance that the authorities would not go after the bank. If true, the decision to pursue JP Morgan might be viewed with a degree of circumspection. A regulatory renege in this way certainly does not engender regulatory engagement and mutual trust and confidence.

More broadly, as Mr Guerrera observed, "the stakes are high, even beyond the $13 billion [being the proposed JPM/DoJ settlement sum]. Wall Street executives and some lawyers warn that if J.P. Morgan is found liable for the WaM…other banks will think twice before buying failed rivals." Effectively - it is suggest by certain US lawyers - "…the government will ensure that no bank ever buys another rival in distress."

Are we therefore to conclude that, if the purpose of regulatory enforcement/prosecutorial action is to punish (remediate) and deter wrongdoing, there needs to be a direct link to that wrongdoing? This might explain the cynicism with which certain people have viewed the US authorities' reliance on the favourable evidential and limitation provisions within the US "FIRREA" legislation to simply "get home" on prosecutions such as that pursued against JP Morgan. Having said that, if there exists wrongdoing, should the authorities not be at liberty to utilise whatever legal tools are available to them to bring individuals (and, vicariously, their employers) to book?

In any event, if ultimately JP Morgan foots the bill for WaMu's misconduct, does this then suggest that balance sheet culpability is just as sound a basis for financial liability? Of course, you might say that JP Morgan assumed responsibility for pre-acquisition misconduct implicitly in the purchase price discount it negotiated at the time: essentially, the consideration it paid reflected the allocation of risk between the parties. On the other hand, you might rightly argue that financial responsibility ought not be the basis of liability for misconduct, as opposed to other forms of corporate liability, unrelated to wrongdoing - certainly so, if you consider the intangible reputational cost to the bank arising out of this legacy misconduct. One can anticipate these arguments and each has some merit. But the 'right and proper' conclusion (enforcement/prosecutorial policy) is not so easily sketched out and the legal risk inherent in these issues is palpable.

There are clearly many issues that arise out of the recent conduct costs phenomenon. Certainly, this short commentary proffers more questions than answers. But this is intentional: its purpose is to raise awareness of the issues and spark debate on the subject of conduct costs and the wider implications for not just regulated firms but for regulatory policy and approach. And I certainly believe that the LSE Conduct Costs project offers an excellent nonpartisan forum in which air these issues – alongside the risk management utility of the project data. I welcome views on the issues raised here and to an on-going and constructive dialogue.

About the author:

Christopher Stears: Candidate for PhD, Institute of Advanced Legal Studies