Banks pay a heavy price for the crisis, but fail to count the cost

By Roger McCormick and Chris Stears | September 2014

The major international banks are being lumbered with more and higher fines as the fallout from the financial crisis continues. Our research as part of the Conduct Costs Project at the CCP Research Foundation is providing evidence of the escalating financial penalties, but the banks remain mute and there needs to be much more to the sector's renaissance than a simple shaming through sanctions.

For the five years to the end of 2012 the conduct costs for ten key banks were at just under £150 billion. For the five years to the end of 2013 they were just under £160 billion. The figures for the period ending 2014 cannot be produced yet, of course, but this year has already seen record costs **imposed on Bank of America** – $16.65 billion (£10.3 billion) – for mis-selling mortgage-backed securities (MBS) and a **massive $8.9 billion fine** slapped on BNP Paribas (much to the consternation of the French government) for violating US sanctions against doing business with some pretty unpleasant regimes.

Citigroup took a $7 billion hit over MBS and **UBS took around $300m on the chin** to settle a German case about assisting tax evasion. Space is tight, but there are plenty more: **Standard Chartered's money-laundering issues**; **Lloyds and LIBOR**….

Measuring the pain

We started the Conduct Costs Project, around two years ago, because no one was keeping a log of these massive fines, compensation payments and other costs associated with misconduct. No national regulator or international body, seemed to think it would be of interest to the public or relevant to how we assessed banks' post-crisis behaviour.

However, at a time when banks are telling the public that they want to regain our trust, surely the track record of those facing regulatory action is an important indicator as to just how trustworthy they actually are? And our net is spreading; the study will cover more than 20 international banks by the end of this year.

It amounts to more than just the airing of banks' dirty laundry and it is not something that they should approach with antipathy. There are lessons here in respect of the link between conduct and culture; the benefits of ethics-led decision making; the best practice for bank governance and conduct risk management; the unintended consequences of regulatory enforcement trends; and a means by which the restoration of trust and confidence in banks can be measured and compared.

It is clear, for a start, that investors and other stakeholders are beginning to take seriously the implications of conduct risk and to understand just how useful it can be to have a transparent approach to the costs involved. The industry, however, is lagging behind: banks on the whole are not making use of the intelligence and trends available from their own data. They are not sharing their experiences or discussing the grey areas that, contrary to what appears to be prevailing policy, should not be approached in a proprietary way, but should be part of an industry-wide debate. Effectively managing conduct risk and building stakeholder trust and confidence is not a matter for competitive advantage.

Be damned and publish

The authorities are beginning to catch on. The European Banking Authority is reported to be about to publish **at least some information about EU bank fines** when it publishes the results of its "stress tests" later this year. This, we hope, might shed some much needed light on a very shady area in respect of misconduct disclosure – the fact that Eurozone regulators are being very secretive about how and when they discipline their banks. In the UK, the Banking Standards Review has acknowledged that conduct costs can serve as a "metric" for measuring a bank's success in operating as a more professional, ethically based institution.

It is true that some of the conduct costs data relate to "legacy issues" and at least some of the banks may have a case for saying they are now better than they used to be. Even a very large fine recorded in 2014 may not be a wholly reliable indicator of how good or bad a bank is in 2014. However, the task of interpreting the numbers is not helped by the banks' habit (to some extent, encouraged by regulators) of refusing to give the public any meaningful comment about fines when they are levied. In most cases, all we hear is: "thank heavens that's all over and done with; now we can put it behind us and move on".

You can't help feeling that a bank which provides the public with such glib, virtually empty announcements after parting with humongous sums of money due to misconduct has not yet really got the message.

Getting trust up

So what exactly is the message? Banks could perhaps begin by asking themselves, individually and as a sector, some of the questions that seem to keep being ignored. Try this. If you are genuine in your protestations that you want to regain public trust, what would you say you need to do to earn it? Is it just a question of "keeping a clean sheet" and staying out of trouble for as long as possible? Or do you need to show that you have actually changed in a more tangible, evidence-based way? How would your employees describe their duty of care to your bank and to your retail clients – and to the institutions on the other side of your deals. How about the duty of care to the broader market or the public?

Here's a scenario that might give a banker some food for thought. Supposing the institution on the other side of a deal has made a fundamental error in its understanding of a transaction's documentation, such that, if it is not alerted, it will lose (and you will gain) a very large sum of money. Do you tell them? Is it really just tough luck if they don't spot the problem?

Would your answer be different if the counter party was represented by a friend of yours? You know that if you don't say anything they might lose their job and have to sell the family house. Happy to stay silent? If you give a different answer to the two scenarios, how do you rationalise that? Is it because you have a greater duty to a friend than to a relatively "anonymous" counter party? How does this reflect on your broader duties to the market, bearing in mind your CEO's statements about your integrity and ethical awareness?

We don't have the answers to all questions of this kind but what we do know from conversations with market participants is that banks need to think more deeply about them than they have been. And this needs to be done in a manner visible to the public; not only individually but across the sector.

Collective discussion and agreement on how to respond to the "difficult" grey areas in ethics is a hallmark of "professional" behaviour that we see across all the classical professions. The banks need to think about how this should translate to problem areas as a matter of urgency. Faced with the drama and public flogging of massive fines, the greatest danger is complacency as to the size of the tasks that still have to be undertaken. The banking business model is changing, as is the standard of behaviour that the public expects. The message, in short, is that we want to see real change for the better: fine words (and fines) will not be enough.

The article was first published in The Conversation on (17 September 2014), available at (http://theconversation.com/banks-pay-a-heavy-price-for-the-crisis-but-fail-to-count-the-cost-31151).

About the authors:

Roger McCormick: A former Freshfields partner and former Visiting Professor at London School of Economics.

Chris Stears: PhD Candidate at Institute of Advanced Legal Studies.