



Misconduct Costs

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According to a late 2020 study,¹ three countries—the US, Australia, and Israel—accounted for 97% of the nearly €12 billion in bank fines issued last year.² Notably, costly conduct scandals also threatened to further a recent shake up in the leadership ranks of European firms.³ In the Netherlands, ABN Amro reached a €480 million anti-money laundering settlement with Dutch prosecutors just last month.⁴ Between them, European and American firms have faced some \$400 billion in misconduct fines since the Financial Crisis.⁵ In Asia, risk governance and compliance costs are estimated to have increased by some 20% year-on-year in 2020.⁶



The Operational Risk Exchange (ORX)—an industry association of operational risk leaders at the world’s largest financial institutions—estimates that its member firms experienced operational risk related losses of €482 billion in the period 2014 through 2020, misconduct counting for much of that cost. An exhaustive accounting of misconduct costs experienced across the industry globally in the last year falls outside our present scope, but there are particular instances of note that warrant attention here.

Last September, Australia’s Westpac Banking Corp paid the largest fine in Australian corporate history, AUD \$1.3 billion, to settle charges brought by financial crimes regulator AUSTRAC, the Australian Transaction Reports and Analysis Centre. AUSTRAC head Nicole Rose said the size of the penalty reflected the “serious and systemic nature” of Westpac’s

breaches.⁷ In October the firm announced a \$1.2 billion hit to its earnings driven by misconduct costs.⁸ And in December, the Australian Prudential Regulation Authority (APRA) required that Westpac increase cash reserves after a review of the bank’s risk management found it had incorrectly calculated several key capital ratios through 2019 and 2020, reflecting “weaknesses in risk management and oversight, risk control frameworks and risk culture.”⁹ The firm agreed to a court-backed enforceable commitment with APRA, pledging to address “long-standing weaknesses” in its risk controls and poor risk oversight. In a statement, APRA concluded that Westpac had failed to deliver expected risk governance improvements despite almost two years of remediation.¹⁰

Bank Governance Conduct Deficiencies

Governance Issues Have Resulted in Record Fines, Regulatory Scrutiny

Date of Most Recent Fine	Bank	Fine/ Restitution	Governance/Conduct Deficiency
Oct 20	Deutsche Bank	\$196m	Deficient risk management/internal controls; market manipulation/spoofing
Oct 20	Goldman Sachs	\$5.1b	Deficient risk management/internal controls
Sept 20	JPMorgan	\$920m	Market manipulation/spoofing
Sept 20	Citigroup	\$400m	Deficient risk management/internal controls
Aug 20	Capital One	\$80m	Deficient risk management/internal controls
Aug 20	Bank of Nova Scotia	\$127m	Market manipulation/spoofing
Aug 20	TD Bank	\$122m	Customer welfare; inadequate disclosure regarding consumer debit card

Source: Fitch Ratings

In September, JP Morgan entered into a Deferred Prosecution Agreement with the Department of Justice and agreed to pay a \$920 million fine to settle criminal charges relating to claims that it had sought to defraud precious metals and US treasuries markets.¹¹ “For nearly a decade, a significant number of JP Morgan traders and sales personnel openly disregarded US laws that serve to protect against illegal activity in the marketplace,” said Assistant Director in Charge William F. Sweeney Jr. of the FBI’s New York Field Office. “JPMorgan engaged in two separate years-long market manipulation schemes,” said US Attorney John H. Durham of the District of Connecticut. “Not only will the company pay a substantial financial penalty and return money to victims, but this agreement requires JPMorgan to self-report violations of the federal anti-fraud laws and cooperate in any future criminal investigations.” In November, JP Morgan faced a \$250 million fine from the OCC for “deficient” risk management practices and insufficient controls in its asset and wealth management business.¹²

Regulators increasingly appear to be arguing that poor risk governance and compliance controls create conditions for unacceptable levels of both financial and non-financial risk. Because the management of financial risk involves staff responsible for maintaining related controls in a timely, efficient and effective manner, cultural issues and behavioral norms that interfere with or undermine financial risk control measures would imply that non-financial risks *are* financial risks, and that misconduct concerns are all the more so a systemic risk factor for the industry.

In October, US regulators chastised Citigroup over “longstanding deficiencies” in its risk and control systems. In a Consent Order agreed to by the bank, the Federal Reserve found that Citigroup “has not taken prompt and effective actions to correct practices previously identified [in] compliance risk management, data quality management, and internal controls”. The firm was ordered to upgrade its processes and its technology. Along with the

Fed’s action, the Office of the Comptroller of the Currency (OCC) issued a similar order and levied a \$400 million fine against the bank,¹³ demanding it take corrective actions including “the thorough redesign of data architecture, re-engineering of processes, and modernization of system applications and information technology infrastructure.”¹⁴ The regulatory actions are said to have contributed to CEO Mike Corbat moving up a planned 2021 retirement so that current CEO Jane Fraser could decide and oversee implementation of the necessary risk governance reform effort.

Again in October, Goldman Sachs entered into a DPA with the Department of Justice, admitting to wrong-doing and agreeing to pay \$2.9 billion for its role in Malaysia’s 1MDB scandal.¹⁵ In all, the 1MDB scandal has cost the firm some \$5 billion, leading its board to take the unprecedented step of clawing back \$174 million in past payments to the firms’ senior-most leadership.¹⁶ Goldman has pledged to heighten scrutiny of those senior executives engaged in high risk areas of its business.¹⁷ Notably, the DPA commits the firm to ensuring that, based on any future analysis of any misconduct, it will “conduct a thoughtful root cause analysis and timely and appropriately remediate to address the root causes.”¹⁸ It is as yet unclear, but perhaps reasonable, to anticipate that a Biden DOJ will expect firms to take their culture into account when inquiring into the root causes of misconduct and risk governance failures.

In May of last year, it was reported that Wells Fargo had lost some \$220 billion in market value as a consequence of an ‘asset cap’ imposed by Janet Yellen, then Chairman of the Board of Governors of the US Federal Reserve (and now Secretary of the Treasury).¹⁹ In August, reports suggested that the asset cap had cost the firm \$4 billion in lost profits that its shareholders might otherwise have enjoyed had the cap not been in place, making it one of the most expensive bank penalties ever imposed.²⁰



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Current CEO Charlie Scharf announced dramatic cuts to the firm’s consultancy spend after an internal backlash against outlays that had reached some \$1bn-\$1.5bn yearly, with most of that going to remedial efforts aimed at satisfying the Fed’s concerns so that it might see fit to lift the asset cap.²¹ According to SEC filings, Wells Fargo has spent nearly \$12 billion on consulting fees since 2017 alone.²²

In its 2020 annual “Cost of Compliance” report, Thomson Reuters finds that, among the most significant compliance challenges boards expect to face are balancing budgets in the face of increasing compliance costs, driving demonstrable cultural change, and increasing personal accountability. Around a third of the firms surveyed by Thomson Reuters reported that they had discarded potentially profitable business opportunities out of concern for culture or conduct-related risks.²³ Another recent study estimates that compliance costs in 2020 consumed some 5% of overall firm revenues.²⁴ “With the impacts of COVID-19 and the challenges of a

remote workforce, investment in compliance will continue to be a top priority for financial services firms this year,” the report concludes.

Despite such levels of compliance spend, US banks are thought to have racked up some \$200 billion in punitive fines in the last 20 years due to misconduct and risk governance failures.²⁵ It is little wonder that the Operational Risk Exchange finds conduct risk among the top concerns reported by its member firms. “For eight years now, we have collected a library of top operational risk scenarios from the financial institutions we work with, and employee conduct is a subject that comes up every year,” said Steve Bishop, Head of Risk Information at ORX.²⁶



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