Will Conduct Costs Change the Behavior of Banks?

Calvin Benedict*

Abstract: Following the Global Financial Crisis, the banking sector has faced an unparalleled level of regulatory fines and court settlements. This form of financial liability has been broadly termed as ‘conduct costs’. The article looks at this phenomenon analyzing the implications of conduct costs, JP Morgan’s recent settlements and the ‘Conduct Costs Project’ research initiative led by London School of Economics Visiting Professor Roger McCormick. Several insights into the meaning behind the conduct costs figures as offered, as well as a discussion on the future of such costs and regulatory actions of the European Commission. The article concludes with a call for continued research into this area to further assess the ethical performance of banks, and draw verifiable comparisons between the different banks and regulatory regimes.

Introduction

Last year, Chancellor George Osbourne made an impassioned pledge to “reset [the] banking system”.¹ The onslaught of fines, lawsuits and settlements which have followed are clear indications of regulators as well as politicians seeking to placate public opinion through compensatory justice for current and past misdeeds by financial institutions. Indeed, a Financial Times article in December 2013 eloquently captured the renewed vigour in which banks are now fined: “Another day, another set of big regulatory fines... Barely a week goes by without one or the other being chastised over past sins”.²

---

* Calvin Benedict is a researcher and holds a BCom Honours in Commercial Law (1st class) from the University of Auckland. Calvin’s research interests include financial regulation and policy, banking law and corporate disclosure practices

¹ “George Osborne: this is the year we reset banking system” The Telegraph (February 4, 2013). Accessed online: http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/9847209/George-Osborne-this-is-the-year-we-reset-banking-system.html

² Jenkins, Patrick “Banks’ rate-fixing fines merit more investor concern” Financial Times (December 4, 2013). Accessed online: http://www.ft.com/intl/cms/s/0/4bd70d1e-5ce8-11e3-a558-00144feabdc0.html#axzz2nDL48dqf
Conduct costs

To perhaps account for this crescendo in regulatory and litigious action towards banks, the term ‘conduct costs’ has recently surfaced into the lexicon of the banking sector. In essence, conduct costs relate to money that banks pay out in the form of fines to regulators or ‘redress’ required by regulators. They may also include other forms of payments, for instance:

- “a) sums paid in settlement of regulatory proceedings (whether or not there is any ‘admission of wrongdoing’)"
- “b) sums paid in settlement, or at the conclusion, of litigation that is based on an allegation of a bank’s misconduct or that of its officers (although it is not intended to cover all litigation costs, whatever the nature of the claim)"
- “c) sums paid for the repurchase of securities from the market (because they were mis-sold) at the behest of regulators"
- “d) egregious losses caused by a bank employee’s serious misconduct and/or attributable to poor risk management.”

In this way, practices like mis-selling payment protection insurance, benchmark manipulation and breaching money laundering rules fall under the purview of conduct costs.

JP Morgan’s recent fines

JP Morgan has seen itself at the receiving end of this clampdown in the banking sector. Last year alone the bank has entered into settlements over the “London whale” debacle, in addition to a US$13 billion fine concerning toxic mortgage-backed securities, which includes a US$4 billion fine with the Federal Housing Finance Agency. To exacerbate matters, JP Morgan has refused to enter into an agreement with the European Commission (EC) to end a cartel investigation into Euribor manipulation and, thereby, faces heightened legal risks in the form of a court challenge and increased fines. In an almost

---

4 Ibid.
6 Sebag, Gaspard “JPMorgan Said to Snub Euribor Deal as EU Readyies Bank Fines”
Comical twist of fate, these settlements, albeit relating to past misdeeds, have coincided with the bank increasing its annual budget for compliance and risk by US$1 billion, and hiring an extra 4,000 staff to service the area.\(^7\)

There are also political and ethical dimensions to the US$13 billion settlement that, hitherto, appear to be understated: JP Morgan has reportedly confirmed that 80% of the misconduct covered by the settlement stem from Bear Stearns and Washington Mutual, both of which were taken over by JP Morgan in 2008.\(^8\) However, according to some commentators, at the time of these acquisitions it was widely known that given JP Morgan’s strong market position, it was pressured by the US government to acquire troubled banks to stabilize the US economy.\(^9\) Several market participants purportedly seemed to have certainly held this view after the Bear Stearns acquisitions.\(^10\) Thus, the underlying criticism is that the bank was pressured to make certain acquisitions by the government and subsequently finds itself subject to fines for this. This criticism does not take away from the culpability of Bear Stearns or the consequent victims of mortgage foreclosures, but should the US government also shoulder some responsibility? More importantly, is it just for JP Morgan to pay for misdeeds that it did not commit? An ethical analysis of these issues exceeds the parameters of the article. Nevertheless the ensuing settlement, *inter alia*, serves as a timely reminder of the enhanced – and sometimes unforeseeable – legal risks that financial institutions must come to terms with in a post-LIBOR scandal era.

### The effect of conduct costs

Conduct costs affect profitability and capital positions of banks but the actual degree to which this is the case is open to polarized opinion. Many CEOs and

---


senior management of banks have also vacated their positions after the imposition of conduct costs, potentially affecting the overarching strategic direction of the banks. As a result, because of the systemically important status of banks, conduct costs can have wider macroeconomic implications and indirectly shape broader societal welfare. It is clear, therefore, that the effects of conduct costs are considerable.

That said, there has been an echoing chorus that the conduct costs imposed on banks are simply not adequately sufficient to deter future misdeeds and more criminal prosecutions may serve as a realistic avenue to overcome this deterrence gap. On this point, Associate Professor William Black asserts that the banking sector has produced “intensely criminogenic environments” driven by deregulation, de-supervision and de-facto criminalization.11 The notion of de-facto criminalization in finance emanates from the view that those who were largely responsible for Global Financial Crisis have never faced criminal prosecution. The scarcity of criminal prosecutions is particularly concerning as it may increase the prevalence of opportunistic control fraud12 in which senior management bypass corporate ‘checks and balances’ for personal gain.

Accordingly, a Wall Street Journal article derisively summed up the efficacy of JP Morgan’s US$13 billion fine:13

“The density of the fog surrounding the deal has given cover to a few misleading claims on its implications... [One of the most common claims:] J.P. Morgan shareholders are the biggest losers from the entire affair. That is technically true: The bank will pay the $13 billion out of reserves that could otherwise have been invested in the business or returned to investors through dividends or share buybacks. But that is only part of the story. For a start, some $7 billion is eligible for tax deductions, enabling the company and, by extension, its owners to save a pretty penny on tax bills. Second, removing the uncertainty of the case has helped the stock. Since last Tuesday [November 19, 2013], the bank’s shares are up more than 3%, outperforming the market. If this trend continues, by next week J.P. Morgan’s market value would have increased by more than the $13 billion it paid the government, a testament to the strength of its business”.

Further, when banks enter settlements with regulators, this is never usually accompanied with any admission of guilt. Following the US$13 billion settlement, JP Morgan Chairman and CEO Jamie Dimon only went as far to say that “we are pleased to have concluded this extensive agreement”. If there is no genuineness in acknowledging misdeeds, one can easily sympathize with the blunt assertion that these settlements have become almost a PR stunt in certain aspects. The public is happy that banks are fined, banks are happy to not be drawn into long-winded court settlements with the (almost certain) possibility of higher legal costs and the regulator can say that they have done their job. However, the cynic in me is left wondering, if fines are viewed by banks as akin to a regulatory tax, all part and parcel of doing business? Ultimately, one is left hoping that these settlements, at the very least, trickle down to the people who have actually suffered. There is, however, doubt to this hope.

Within the wider ambit of conduct costs, a utilitarianism argument – advocating the greatest good for the greatest number – can be found at opposite ends of the opinion spectrum. On the one hand, it could be argued on an anecdotal level that a zero tolerance regulator seeking to impose conduct costs for every misdeed has a populist societal appeal insofar as forcing banks to behave more ethically. On the other hand, it could be equally asserted that society will bear the brunt of the conduct costs as banks withdraw from transactions that come under particular regulatory scrutiny, say, legitimate money transmissions to developing countries that may (by the mere nature of the transaction) be associated with money laundering and terrorist financing. With a lack of empirical evidence, beyond conjecture and supposition it is difficult, if not impossible, to conclusively state whether the former or latter narrative is more compelling.

**London School of Economics Conduct Costs Research**

Fortunately, a research initiative, aptly named “Conduct Costs Project”, led by London School of Economics Visiting Professor Roger McCormick could provide the pathway for a greater debate on the issue. The initiative examined conduct costs, between 2008 and the end of 2012, accrued by 10

---


15 LSE Sustainable Finance Project “LSE Conduct Costs Project Blog”. Accessed online: http://blogs.lse.ac.uk/conductcosts/
leading global banks in the UK, Europe and America, and revealed the following results: 16

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>JP Morgan Chase &amp; Co</td>
<td>18.52</td>
<td>6.13</td>
<td>24.65</td>
</tr>
<tr>
<td>UBS</td>
<td>23.69</td>
<td>0.95</td>
<td>24.65</td>
</tr>
<tr>
<td>Citigroup, Inc</td>
<td>8.71</td>
<td>3.13</td>
<td>11.84</td>
</tr>
<tr>
<td>Lloyds Banking Group PLC</td>
<td>5.87</td>
<td>3.37</td>
<td>9.24</td>
</tr>
<tr>
<td>HDBC</td>
<td>4.03</td>
<td>2.22</td>
<td>6.25</td>
</tr>
<tr>
<td>Barclays PLC</td>
<td>3.06</td>
<td>2.00</td>
<td>5.06</td>
</tr>
<tr>
<td>Royal Bank of Scotland</td>
<td>1.73</td>
<td>2.51</td>
<td>4.24</td>
</tr>
<tr>
<td>Santander</td>
<td>2.70</td>
<td>1.44</td>
<td>4.14</td>
</tr>
<tr>
<td>Goldman Sachs</td>
<td>1.76</td>
<td>2.19</td>
<td>3.95</td>
</tr>
<tr>
<td><strong>Grand Total (GBP bn)</strong></td>
<td><strong>100.48</strong></td>
<td><strong>47.52</strong></td>
<td><strong>148.02</strong></td>
</tr>
</tbody>
</table>

The findings on conduct costs bring a number of important discussion points to the fore, including the effectiveness of legal risk management. Ideally, these findings should also inspire further acknowledgement among regulators and banks of the enormous implications linked to the amount of conduct costs incurred, which appears to not have been given due consideration by either party.

For the purposes of this article, however, the pertinence of such numbers allows us to analyze an ethical proposition, i.e., relatively high conduct costs are an indicator of “ethical under-performance”, whereas relatively low conduct costs suggest that a bank is more ethically sound. 17

It must be stressed, at the risk of stating the obvious, that this proposition is not watertight. This is partly owing to the consequentialist nature of such a proposition in that ethics is assessed purely through the parochial scope of outcomes-based conduct costs. Three situations come to mind that distort the relationship between ethics and conduct costs:

---

16 LSE Sustainable Finance Project “LSE Conduct Costs Project Blog – Bank Conduct Costs Results”. Accessed online: http://blogs.lse.ac.uk/conductcosts/bank-conduct-costs-results/

i. Banks may have behaved in an unethical manner yet still incur no conduct costs.

ii. The proposition does not capture ‘positive’ ethics when a bank exceeds its ethical obligations to customers and regulators, and only captures ethical failings to the extent this is realised in conduct costs.

iii. A bank may not have ethically underperformed but still accrued conduct costs. For example, the JP Morgan US$13 billion settlement throws caution to the ethical quandary of whether a firm should pay for the misdeeds of another firm it was arguably pressured to acquire.

Although the proposition – that lower conduct costs are indicative of more ethical behaviour – is by no means a definitive measure of a ‘greening’ ethical process in finance, it is arguably one of the best measures currently available. To this end, due to a lack of information on how to measure ethical behaviour between financial institutions, especially from an empirical viewpoint, the proposition (and research initiative) undoubtedly suffices as an encouraging and viable starting point.

Meaning behind the figures

The aphorism ‘knowledge is power’ is said to be derived from the Latin phrase scientia potentia est. These figures offer us the power through constructive dialogue and interpretation to gain substantial headway in forging the future of the banking sector.

First, to contextualise the figures, it is worth stating how they were derived. According to the Conduct Costs Project’s “Notes on Interpretation”, all figures must be viewed as “approximate” since they are taken solely from data in the public domain and in some instances this includes “incomplete information”.¹⁸

This shortfall should be deflected towards banks for a lack of transparency in accounting and disclosure practices. Subsequently, some form of global consistency must be achieved in how conduct costs figures are presented to stakeholders. Presently, the “GR4 Sustainability Reporting Guidelines” published by the Global Reporting Initiative lays out a framework that stipulates the reporting of the total monetary value of significant fines and non-monetary sanctions.¹⁹ Pleas for greater transparency in the public arena tend to be viewed with a degree of circumspection for the fear of ‘information

---

¹⁸ LSE Sustainable Finance Project “LSE Conduct Costs Project Blog – Notes on Interpretation”. Accessed online: http://blogs.lse.ac.uk/conductcosts/notes-on-interpretation/

overload’, whereby stakeholders become inundated with the vast amount of available information and are unable to act on material disclosures. A consistent approach to disclosure of material information, including conduct costs, that allows for uniformity and comparison will mitigate the effects of information overload.

Secondly, the total figure of nearly £150 billion for just 10 banks in conduct costs critically challenges the way in which funds are allocated on a global and societal level. On this issue, Professor McCormick comments that to put that the £150 billion into context, the annual budget of the 24 richest nations for international aid is just over £80 billion, and the annual budget for the UK National Health Service is just over a £100 billion. It is regrettably a truism that conduct costs have reached such dizzying heights to levels comparable to the gross domestic products of Singapore and Greece.

Alarming statistics like conduct costs and the plague of financial crises which have engulfed world economies continue to provide plentiful weight to discredit ideologies of (unbridled) capitalist systems. Global luminaries such as Pope Francis have voiced their beliefs on this matter:

“Today everything comes under the laws of competition and the survival of the fittest, where the powerful feed upon the powerless... Some people continue to defend trickle-down theories which assume that economic growth, encouraged by a free market, will inevitably succeed in bringing about greater justice and inclusiveness in the world. This opinion, which has never been confirmed by the facts, expresses a crude and naive trust in the goodness of those wielding economic power and in the sacralized workings of the prevailing economic system... While the earnings of a minority are growing exponentially, so too is the gap separating the majority from the prosperity enjoyed by those happy few. This imbalance is the result of ideologies which defend the absolute autonomy of the marketplace and financial speculation... Ethics has come to be viewed with a certain scornful

---

20 LSE Sustainable Finance Project “LSE Conduct Costs Project Blog– ‘Interview with the Project’s Director, Roger McCormick’”. Accessed online: http://blogs.lse.ac.uk/conductcosts/2013/10/29/conduct-costs-project/


derision. It is seen as counterproductive, too human, because it makes money and power relative”.

There is also a secondary caution of reconciling the ideologies of capitalist markets with sustainable (environmental, social and governance) practices that enhance the wellbeing of future generations. This is of particular importance given that the Eurozone Crisis has coincided with record highs in youth unemployment – the afflicted individuals being termed by the media as the “Lost Generation”.

Thirdly, insofar as the figures showcase the difference in regulatory approaches between jurisdictions, it may add to the globalization debate on financial reforms. As a corollary to the first point, from an accounting perspective, seeing how conduct costs are disclosed in different jurisdictions, could underline deficiencies in nationalistic corporate accountability. Also, if a certain type of misdeed continually occurs in a particular jurisdiction this, in turn, may warrant cause for legal reforms or a more credible regulatory threat. Moreover, studying why some regulators impose heavier fines in certain jurisdictions may shed further light on the cost-benefit analysis of fines and the need for a greater number of criminal prosecutions.

Fourthly, and one of the most enviable advantages of such research is that the figures allow for comparison between banks. *A priori*, there is an obvious caveat to such a comparison as the studied banks are not the same size and operate on varying business models in different jurisdictions.\(^\text{23}\) This may muddy up the waters, so to speak, between ‘good’ and ‘bad’ apples. However, to a large degree, banks are still merely judged on bottom line profitability and a migration away from this paradigm, notwithstanding some drawbacks, offers future palpable and pragmatic benefits. Here, it is crucial to differentiate between industry problems and firm-specific failings so as to encourage competition between banks.

On December 4, 2013, the EC levied fines on eight international banks for their involvement in illegal cartels in markets for financial derivatives spanning the European Economic Area.\(^\text{24}\) On the basis of this settlement Joaquin Almunia, Vice-President of the EC in charge of competition policy, provided a forthright assessment of the cogency of competition: \(^\text{25}\)

> “What is shocking about the LIBOR and EURIBOR scandals is... the collusion between banks who are supposed to be competing with each other. Today's decision sends a clear message that the Commission is

\(^{23}\) See footnote 18.


\(^{25}\) Ibid.
determined to fight and sanction these cartels in the financial sector. Healthy competition and transparency are crucial for financial markets to work properly, at the service of the real economy rather than the interests of a few”.

Finally, these figures draw us into a fundamental introspection of what the actual purpose of finance is. In its simplest terms and as a conceptual basis, the purpose of finance is to assist people to “save, manage and raise money”. Recent decades saw the accelerated development of multinational corporations and increased economic integration across nations, partly due to the proliferation in cross-border mergers and acquisitions during the 1990s. Financial institutions followed this trend to profit from opportunities bestowed upon by global markets. The advent of economic globalisation has thus increased the magnitude of financial activity to systemic importance but this paradigmatic evolution has been counter-balanced by conduct costs rising to unprecedented levels. It is at this critical juncture that we must ask: does the end justify the means? Are the conduct costs of £150 billion for financing a global economy for approximately five years just another ‘cost’ of doing business? In short: no. Wilfully non-compliant and reckless misdeeds by banks that manifest themselves into conduct costs are inexcusable.

**Future of conduct costs and LSE Research**

If 2013 was indicative of the upcoming years, then, conduct costs show no signs of abating. Professor McCormick aims to expand and continue the Conduct Costs Project on a rolling five-year basis. This is, however, dependent the funding package they have at their disposal as they initially operated on a budget of only £37,000. The accuracy of the conduct costs figures will also be subject to the future involvement of banks and regulators. If banks truly want to engender a more favourable societal view and demonstrate genuine commitment to meaningful change then this is an opportunity to do so.

Again, the political aspects of conduct costs warrant mentioning. There is a barrage of questions that, thus far, remain unanswered: In situations where the

---


scope of misdeeds can be attributed a standard industry practice, is there a political agenda behind targeting certain banks first for their misdeeds? How do regulators calculate settlement amounts, and is this influenced by the economic and political climate? And so forth. This article has called for greater transparency among banks, and must duly ask the same of governments and regulators.

European Commission

As an auxiliary consideration, the future levels of conduct costs in the European Union will, in part, be determined by the EC’s cartel settlement procedure. In the canvass of this procedural regime, two features are of particular relevance:

i. Banks can receive full immunity for revealing the existence of cartels. This was the case for UBS in the aforementioned cartel settlement, in which it avoided a fine of approximately €2.5 billion.29

ii. Under the EC’s leniency programme, banks can also be granted a 10% discount in their fines for agreeing to a settlement.30

The axiomatic shortfalls of using incentives to encourage specific, desirable behaviour are well chronicled.31 However, the EC is of the belief that both settlement mechanisms benefit consumers through lower costs, free up resources for its antitrust enforcement arm to pursue other cases, and allows for companies to reach an outcome at a faster rate with a reduction in fines.32 Arguments of whether to increase the level of detection as a substitute for granting more leniencies continue to propagate.33 Either way, banks should definitely have cause for concern as the willingness of the EC to pursue multiparty cartel proceedings (in contrast to the bank-by-bank approach typically taken by the UK and US) signifies a tangible threat to collusion, takes away any political agenda of targeting a specific bank first and therefore means banks collectively suffer for their misdeeds.

29 See footnote 24.
30 Ibid.
32 See footnote 24.
Conclusion

The LSE Conduct Costs Project is a progressive endeavour that (i) represents an empirical attempt of measuring ethical performance to create an understanding of the extent to which banks have changed their behaviour and (ii) allows for comparisons between banks and their competitors, and the approaches of different regulatory regimes.

It cannot be highlighted enough, that we all have a vested interest in banks and their future conduct costs. Our savings, loans, investments and wider economic activity are all affected by the levels of conduct costs. It is paramount that we study these figures. To date, we have made a promising start – let’s see it continue.

* * *