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2012 IN REVIEW

*Enforcement*

# 2012: Annus Horribilis for the Banking Industry

By Paul L. Lee

The year 2012 proved to be an *annus horribilis* for the banking industry at least from the perspective of regulatory and enforcement risk. Some might counter with the observation that 2012 was simply another *annus horribilis* in a series of such years for the banking industry. But by virtually any measure the horrors of 2012 exceed those of prior years. The regulatory and enforcement developments in 2012 prompt the question whether a permanently heightened regulatory and enforcement risk profile is now the new baseline for large banking institutions. This essay analyzes the most significant enforcement developments in 2012 and assesses the prospects for heightened scrutiny and increased enforcement action against the banking industry in 2013.

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## Unprecedented Enforcement Action

There is no precedent for the heightened regulatory and enforcement action seen in 2012. A faint precedent at best can be glimpsed from experience in the years following the dotcom crash and the Enron-like scandals. Under the title "Wall Street Fine Tracker," *Forbes* tracked the fines paid by Wall Street firms from 2001 through 2003. It calculated the amount paid in total fines and settlements of class actions by Wall Street firms at almost $3 billion in 2002 and in excess of $4.2 billion in 2003. By contrast, the fines alone paid by UBS, HSBC and Standard Chartered Bank in the month of December 2012 exceeded $3.7 billion, including in the case of HSBC and UBS the two largest individual fines in U.S. banking history. Together with the fines paid earlier in 2012 by Standard Chartered Bank, Barclays and ING, the total for these five institutions exceeded $5.1 billion. Surveying the new enforcement scene, Adair Turner, chairman of the U.K. Financial Services Authority, is reported to have observed — in a private setting — that there is now an "arms race" among the regulators in pursuit of larger fines.

## The Banking Industry as Public Enemy

The individual fines do not begin to tell the full story. They do not take account of the significant potential liability to private litigants, for example, in the LIBOR and other matters. Nor do they take account of the substantial reputational damage done to the institutions involved and the banking industry as a whole. In any event, fines do not appear to satisfy the public demand for retribution. The editorial pages of leading publications have for several years called for criminal prosecutions following the perceived misdeeds that led to the financial crisis. As the details of the LIBOR scandal emerged in June and July of 2012, such estimable publications as *Bloomberg* and *The New York Times* encouraged the law enforcement authorities to seize the

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opportunity presented by these investigations to indict institutions and individuals at last. The announcement in December 2012 of the deferred prosecution agreement with HSBC for anti-money laundering and sanctions law violations resulted in press criticism of the fact that neither the institution nor any individuals were indicted. It also confirmed the suspicion in the mind of many observers that the regulators and law enforcement authorities view large financial institutions as ''too big to indict.''

These criticisms may have been anticipated by the authorities because only a week after announcing the HSBC deferred prosecution agreement, the Department of Justice announced a settlement of LIBOR bid-rigging charges with UBS involving an agreement by a Japanese subsidiary of UBS to plea to a felony count as well as the criminal indictment of two former UBS traders. If the Department of Justice officials thought that the additional criminal action against the UBS subsidiary and former traders would go any distance to satisfy the critics, they were mistaken. *The New York Times* for one concluded that the settlement was structured so as to permit the plea by the subsidiary to shield the parent company and the indictment of the two traders to shield the management of the parent company. In some respects the Department of Justice may have become a victim of its own rhetoric. In announcing the settlement and the plea by the subsidiary, the Department described the UBS bid-rigging as an ''epic'' scandal. *The New York Times* editorial wanly concluded that there was nothing ''epic'' in the Department of Justice response. The equally esteemed *Financial Times* opined in words borrowed from the Department of Justice that the scale of UBS's involvement in the bid-rigging was ''astonishing'' and in its own words that the bank's ''cavalier'' attitude to compliance ''simply beggars belief.''

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The public discourse over the banking industry has acquired a poisonous tone. It has admittedly been many decades since an observer would have presumed to suggest that it might be a wonderful life to be a banker — at least in the popular estimation. The opprobrium currently attached to Wall Street and the banking industry exceeds anything encountered since the time of the Great Depression. One does not require polling results to gauge the public distemper. A casual reading of reportage by the press and declamations by legislators in the U.S. and the U.K. indicates the anger and disdain directed at the financial sector. This anger was on prominent display during the U.S. Senate subcommittee hearing on HSBC and U.K. Parliamentary committee hearings on Barclays in July of 2012. These hearings can be seen in the most generous light as designed to seek truth, but certainly not reconciliation. A Parliamentary Commission has continued the quest in the New Year with hearings on the UBS involvement in the LIBOR bid-rigging scandal.

One may also question whether the press in its reporting and the legislators in their pronouncements simply reflect the public anger or actually amplify it. It is likely a bit of both. In any event it seems clear that the public outcry has influenced the approach of law enforcement and regulatory authorities to their LIBOR and other enforcement actions. When the New York Department of Financial Services pronounced Standard Chartered Bank a ''rogue institution'' in its August 2012 enforcement action, it merely borrowed a phrase used by a member of Parliament to describe Barclays during the Parliamentary committee hearings on the LIBOR scandal. The public anger from the financial collapse and the government financial assistance to the banking sector (to banks both large and small) is still strong and, if anything, will metastasize with each new hint of scandal in the banking sector. *The Wall Street Journal* editorial writers in fact suggest that the LIBOR scandal has become the regulators' surrogate for all that supposedly went wrong in finance before the panic of 2008. It seems that through the inadvertence of some and the malfeasance of others, the banking sector has constituted itself a public enemy. All the current signs suggest that notwithstanding the doubts of *The New York Times*, this *will be* an epic period of regulatory and law enforcement action against the banking sector in terms of penalties and remediation requirements.

## Governance Challenges in the New Enforcement Era

This new era of regulatory and law enforcement action in the banking sector presents significant new challenges for governance in the sector. There are several different perspectives that may be brought to bear on the problem of governance. The first and most obvious perspective is how more robust governance might reduce regulatory and enforcement risk at least for future activities. A related perspective is how more robust governance might help as well to manage the risks of legacy activities, as these risks are actualized through existing investigations and enforcement actions. The banking sector is already experiencing an explosion of liability, some actualized from regulatory fines and settlements of civil litigation, other still potential from pending regulatory and law enforcement investigations and civil litigation, from a wide range of historical business practices and activities. Many of the practices and activities have been changed or terminated, but the prospect of regulatory, law enforcement and civil litigation action against institutions for past practices and activities is substantial and a matter of concern to the market since the ultimate size of any actualized liability is difficult to project.

One additional perspective on governance may come from the analysis of how improved governance might have helped the institutions to identify the risks in their legacy practices and mitigate those risks at an earlier stage. The recent enforcement actions provide useful insights for this historical analysis. In some cases they indicate that an institution's governance and control structure had simply not identified the risk. In other cases they indicate that the risk had been identified by a control function such as compliance but was not addressed because the business function overrode the control function. In still other cases they indicate that the business and control functions identified the risk and the need to change practices but lacked the resources or a sense of urgency to correct the practices. In the most extreme cases there is even the suggestion

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that senior business and control functions may have simply decided as a business matter that they would run the risk of liability. Regulators have long known that control functions in many institutions do not have a strong enough voice and can be easily overridden by the business managers. The regulators will find confirmation of this belief in virtually all of the recent enforcement actions and may find further reason to be concerned that in some cases senior management and control functions were complicit in, or turned a blind eye to, the activity.

The recent law enforcement actions suggest that there is still another perspective to be brought to governance of regulatory and compliance risks. The law enforcement and regulatory actions themselves have had a profound effect on governance, in the short-term leading to the replacement of senior management and board members and in the long-term leading to changes in governance structure and board responsibility. This analysis here partakes of an oscillating nature, alternating between the effects of governance on these risks and the effects of these risks (or more precisely, their actualization from enforcement and litigation actions) on governance. To put this idea in a more pointed way, one might contrast the aspirational effect that sound governance might have on mitigating regulatory and enforcement risk with the demonstrable effect that recent regulatory and enforcement actions have had on governance from the perspective of management and the board. As even a cursory review of the recent regulatory and law enforcement actions indicates, the enforcement process itself has fundamentally affected governance. In announcing its settlement agreements with HSBC and UBS, the Department of Justice specifically noted that each institution had changed its senior leadership and restructured its compliance structure and taken numerous steps to enhance compliance and other control functions. In the case of Barclays, the effects of the law enforcement and regulatory actions on management and board were even more dramatic, playing out virtually in real-time as the Parliamentary committee hearings were in progress. Both the chairman of the board and the chief executive officer were forced to resign. Corporate accountability, as guided not so very gently by the regulators, was particularly swift in its exactions for Barclays.

## The Problem of Complexity

If we are entering a new era of law enforcement and regulatory action against banking institutions, we are likewise also entering a new era of corporate governance. The recent law enforcement and regulatory enforcement actions provide a measure of guidance on the heightened expectations for governance. At bottom, these actions reflect the skepticism of the law enforcement and regulatory authorities about the past and future governance efforts of large financial institutions. At best, the enforcement orders reflect the belief of the law enforcement and regulatory authorities that the largest financial institutions cannot be relied upon to develop robust enough governance mechanisms on their own and that instead the authorities must impose specific and detailed governance measures on the institutions as part of the regulatory or enforcement process. The orders often include detailed requirements for enhanced compliance, audit and board supervision. They may also include a requirement for a third-party consultant to recommend further changes in governance or a requirement for a third-party monitor to supervise and oversee the remedial actions called for in the enforcement order. At worst, some of these orders may reflect the (unarticulated) belief that the largest financial institutions have become too complex for management to manage and for regulators to supervise, leading to the suggestion that these institutions must somehow be made less complex.

The complexity of the largest financial institutions cannot be gainsaid even if the consequences for governance are still to be determined. The range of risk analyses and the diversity of design of control systems necessary to cover such disparate areas as residential mortgage foreclosure practices, credit derivative and other hybrid products, collateralized debt obligation underwriting, and anti-money laundering measures speak of their own difficulties. Although the recent law enforcement and regulatory orders do not expressly deal with complexity risk, other wide-ranging regulatory initiatives are being developed to reduce the complexity of the largest banking institutions. These other initiatives are principally intended to enhance the resolvability of large banking institutions and to limit the range of perceived risky financial activities that might otherwise lay claim to the benefits of a federal safety net. To the extent successful, however, these initiatives may have the collateral effect of reducing at least marginally the complexity of the challenges for compliance and risk management.

The challenges for compliance have increased most obviously as a result of the easing of regulatory requirements beginning particularly in the 1980s that permitted a wider range of affiliations and financial activities to banking institutions. The challenges for compliance have also increased less obviously as a result of a long-term shift in the nature of the business of banking beginning in the 1960s. Some observers have described this shift as a move away from relationship banking to transactional banking. As a short-hand matter, this description serves to define the directional element of change, but not its details or consequences. The prototype of the commercial banking relationship, the commercial loan, for example, involved entering into long-term relationships characterized by a semblance of symmetry of information, i.e., the task of the commercial banker was to obtain enough information about the business and prospects of the commercial borrower to make a judgment about a long-term credit relationship with the borrower. The long-term nature of the commercial lending relationship has significantly changed as a market for the secondary sale of loans developed and as credit derivatives provided a means for modifying the credit and financial relationship between the original lender and the borrower. At the same time the banks expanded their relationship with commercial customers by offering a suite of new financial products, including such ''transactional'' products as derivatives.

As commercial banks evolved into full service financial institutions (for example, with the expansion of their consumer lending activities), the new relationships were frequently characterized by a lack of symmetry of information (for example, in the case of certain mortgage products offered to consumers) or worse by a dissemblance of symmetry of information (for example, in the sale of hybrid products to municipalities and corporate counterparties). These new relationships

were also attended by changes in the bank compensation model with an overriding emphasis on sales promotion. Thus, even when new forms of relationship banking were created, the relationships were unlike those in the historical banking model. The differences in these relationships (such as the asymmetry of information, the relative inequality of negotiating power, and the increased ''salesman's stake'' in the process) produce an environment where the opportunity for abuse, deception and fraud is increased.

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This is not intended as an ethical observation because many of the new products and relationships that have been developed are presumably beneficial to certain categories of customers and hence to the overall functioning of the financial sector. It is simply intended as a practical observation. The new products and new relationships have originated in an environment that lacks some of the natural safeguards of the traditional banking model. The appropriate governance response is to treat the new products and the new relationships as higher risk, requiring greater compliance, audit and other risk management controls. One need not accept the hypothesis of the Becker-Posner Blog (maintained at the University of Chicago Law School) that the circumstances of the modern banking model ''make an unregulated banking industry a Darwinian jungle, with bankers as predators and their customers (and each other) as prey'' to recognize that the modern banking model represents a long-term shift with inherently higher compliance and legal risks than the traditional banking model. The inevitable result will be more frequent and prominent enforcement actions in the banking sector.

## The Problem of Unpredictability

At least for the present, the regulatory system must accept that there will be a substantial element of complexity in the risks that large banking institutions face. The law enforcement and regulatory actions in 2012 highlight, however, another element of risk that may well exceed the risk of complexity. That risk is the heightened element of the unpredictability in regulatory and enforcement actions in the new regulatory, political and market environment. The law enforcement and regulatory actions in 2012 provide ready examples of the new elements of unpredictability. In the case of the Barclays settlement of LIBOR bid-rigging charges, the traditional first-mover advantage in cooperating early and settling first with the authorities was unexpectedly converted into a first-mover disadvantage. While Barclays did achieve one element of a first-mover advantage, i.e., a lower monetary fine than that subsequently imposed on UBS, the conventional advantages for a first-mover were otherwise lost in the public arena. Neither Barclays nor the U.K. regulatory authorities accurately predicted the public and political reaction to the disclosures of Barclays' role in the LIBOR bid-rigging and the fallout from those disclosures. Some commentators have noted that the subsequent disclosures in the UBS settlement for the LIBOR bid-rigging suggest that the role of traders and managers in the UBS case was more extensive than in the Barclays case. At least one commentator has speculated in hindsight, of course, that the reputational damage and outcome for Barclays senior management might have been quite different if the UBS settlement had come first.

Nonetheless, there was surprise too for UBS in its efforts to negotiate a LIBOR settlement with the Department of Justice. UBS had earlier received conditional immunity from the Antitrust Division of the Department for its cooperation in the LIBOR investigation. Based on its early and extensive cooperation, UBS had apparently not foreseen the possibility that as part of its final settlement with the Department it would be required to plead its Japanese subsidiary to a felony offense. Last minute efforts to dissuade the Department of Justice from an indictment and plea by the subsidiary were unsuccessful, according to press reports, because of the extensive involvement of the subsidiary in the bid-rigging scheme.

Surprise too characterized the reaction of Standard Chartered Bank to the public announcement by the New York Department of Financial Services in August 2012 of a enforcement action that could involve a revocation of the banking license for Standard Chartered Bank's branch in New York. Standard Chartered Bank had for some period of time been cooperating with various federal and state authorities investigating U.S. dollar transfers relating to Iran and other countries subject to U.S. sanctions laws. Based on a well-established pattern set in a number of similar prior enforcement proceedings, Standard Chartered Bank could have reasonably expected that any enforcement actions would be coordinated among and issued simultaneously by the various federal and state law enforcement and regulatory authorities. The unilateral action by the New York Department of Financial Services came as a shock to Standard Chartered Bank and the market. It apparently came as a shock to the other federal and state authorities as well. Because of the severe market reaction to the mere threat of a license revocation, Standard Chartered Bank was obliged to reach a settlement with the New York Department of Financial Services within scarcely a week of the initial announcement of the enforcement action. The leverage of the New York Department in pursuing a case principally based on federal law was vastly increased by the market reaction to the threat of a license revocation. Standard Chartered Bank settled with the New York Department of Financial Services for the payment of a $340 million fine. In December 2012 Standard Chartered Bank settled the investigations with all the other federal and state law enforcement and federal regulatory authorities for the payment of a $327 million fine.

## Country Risk in the U.S.

One might ask quizzically as did the *Financial Times* whether prior to the New York Department of Financial Services action, anyone would have supposed that Standard Chartered Bank with its far-flung operations faced its greatest country risk in the U.S. In fact the enforcement orders from 2012 and several preceding

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years highlight the significantly increased regulatory and enforcement risk in the U.S. for global financial institutions. Some observers have suggested based on the actions against Barclays, HSBC and Standard Chartered Bank in 2012 that the U.S. authorities were targeting U.K. based institutions for enforcement action. This is rank speculation that fails to take account of the inherently higher exposures that foreign-based financial institutions face in their operations in the U.S. The business model of most foreign banking operations in the U.S. involves a larger element of cross-border and international business, as for example in wire transfer, correspondent banking and private banking, than most domestic U.S. banking institutions. These particular businesses themselves involve a higher degree of risk to U.S. legal and regulatory requirements, including anti-money laundering, sanctions law, and tax evasion, than many other businesses. Against this backdrop of inherently higher risk resulting from these business lines, some foreign-based institutions have also been slow to appreciate that the regulatory and enforcement attitudes in the U.S. (in many cases already more aggressive than that of the lighter touch regulators in their home country) have rapidly grown even more aggressive, exposing legacy practices in the tax and sanctions law areas in particular to greater scrutiny and challenge.

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The trend lines in most instances should have been clear to foreign-based institutions. The U.S. regulatory and law enforcement authorities have progressively expanded their enforcement efforts aimed at money laundering and terrorist financing activities since the passage of the USA PATRIOT Act in 2001. HSBC, ABN-AMRO, Standard Chartered Bank, and Deutsche Bank were each the subject of a written agreement with the federal and state regulatory authorities in the period between 2003 and 2005 relating to deficient anti-money laundering programs. In 2005 ABN-AMRO was also the subject of a cease and desist order and $80 million in penalties relating to violations of U.S. anti-money laundering program laws and violations of the U.S. sanctions laws involving wire transfers for Iranian and Libyan entities.

Some foreign-based institutions did not respond with appropriate caution to the signals provided by these enforcement orders. Particularly in the case of sanctions law matters, certain foreign-based institutions may have relied on the false belief that U.S. dollar transactions initiated outside the U.S. on behalf of sanctioned countries or parties were not subject to the jurisdiction of the U.S. They may also have been lulled into a false sense of security by the fact that the conduct was not in violation of their home country rules or other applicable foreign rules. These sentiments also appear to have extended to historical activities that involved assisting tax evasion by U.S. citizens and residents in foreign jurisdictions. The enforcement actions of the last few years relating to sanctions laws, tax evasion, and most recently LIBOR bid-rigging confirm that there are virtually no bounds to the jurisdictional reach of U.S. regulatory or law enforcement authorities for conduct or activities affecting the U.S. or its policy interests. This is now an unalterable fact of life in the financial markets.

## Other Lessons

There are other lessons to be drawn from the recent enforcement orders in addition to those already noted. One is simply the complexity of the settlement process itself. Most significant enforcement actions are now multi-pronged and coordinated among multiple law enforcement and regulatory agencies. The anti-money laundering and sanctions law enforcement actions against HSBC involved deferred prosecution agreements with each of the U.S. Department of Justice and the New York County District Attorney's Office and enforcement orders and penalties issued by the Federal Reserve Board, the Office of the Comptroller of the Currency, the Financial Crimes Enforcement Network, and the Office of Foreign Assets Control. The U.K. Financial Services Authority pursued a separate enforcement action with respect to HSBC.

The LIBOR enforcement actions against UBS involved a plea agreement and non-prosecution agreement with the U.S. Department of Justice and coordinated enforcement orders and penalties issued by the Commodity Futures Trading Commission, the U.K. Financial Services Authority, and the Swiss Financial Market Supervisory Authority. The enforcement process against Standard Chartered Bank involved initially an enforcement order by the New York Department of Financial Services and subsequently deferred prosecution agreements with the U.S. Department of Justice and the New York County District Attorney's Office and enforcement orders and penalties issued by the Federal Reserve Board and the Office of Foreign Assets Control. The opportunity for misunderstanding and mishap in the enforcement and settlement process is multiplied by the number of actors and further complicated by the involvement of regulators in multiple jurisdictions. The potential for differing enforcement attitudes and agendas is particularly high in cross-border cases. But as the action of the New York Department of Financial Services against Standard Chartered Bank demonstrates, different attitudes and agendas may exist even within a jurisdiction. One hesitates to refer to any entity as a ''tertiary regulator,'' but it is clear that the power to revoke a license may vault a regulator into a position of prominence that overshadows the authority of other regulators with greater interest and experience in the issues.

The presence of multiple law enforcement and regulatory authorities leads to a competition not in laxity but in severity. The severity may be measured by more than just the size of the fines imposed. The press coverage of the Barclays LIBOR enforcement order emphasized that the Commodity Futures Trading Commission drove the investigation of matters that might more naturally have been thought to be the principal responsibility of one or more of the U.K. enforcement authorities. This case serves as a further confirmation, if any be needed, that the enforcement attitudes and agendas of U.S. regula-

tory and law enforcement authorities will drive global enforcement efforts.

The enforcement action against HSBC signals that the U.S. authorities will take a robust approach not only to the initiation of enforcement action, but also to the ongoing remediation of the problems underlying the enforcement action. The deferred prosecution agreement with HSBC has a five-year term (as contrasted with the two-year term in the UBS non-prosecution agreement). Moreover, the HSBC deferred prosecution agreement requires the appointment of an independent third-party monitor to oversee compliance with the remediation commitments made to the Department of Justice. This oversight will extend to the global operations of HSBC because as part of the deferred prosecution agreement HSBC has committed that its worldwide affiliates will adhere at a minimum to U.S. anti-money laundering standards. HSBC also agreed to complete a review of all its ''know your customer'' files worldwide during the term of the deferred prosecution agreement at an estimated cost of $700 million. This cost is in addition to $300 million already spent on remedial measures by the U.S. operations of HSBC. The resulting scope of remediation and oversight by the monitor may well be the broadest ever imposed on a foreign entity by the Department of Justice deferred prosecution agreement. It represents as well a leading exemplar of the extension of U.S. regulatory standards to the global operations of a foreign banking institution.

## The Domestic Scene

The most prominent law enforcement actions in 2012 involved foreign-based banking institutions. This fact should not be allowed to obscure the enduring risks to which domestic banking institutions are exposed. The range, if not severity, of risk for the largest domestic banking institutions is broader than that of foreign-based banking institutions because the largest domestic banking institutions generally engage in a wider range of financial activities. This is the case, for example, in the retail and consumer banking market, where foreign-based institutions with a few notable exceptions (such as HSBC and to a lesser extent Royal Bank of Scotland) do not enjoy a commanding presence in the U.S.

In the aftermath of the financial crisis there was an intensive legislative focus on the consumer market. This focus was reflected emblematically in the title of the resulting legislative action, the Dodd-Frank Wall Street Reform and Consumer Protection Act. One of the most important initiatives among the many initiatives in the Act was the establishment of the Bureau of Consumer Financial Protection. The Bureau was specifically designed as both a supervisory agency and an enforcement agency. When constabulary duties are to be done, the Bureau's lot is thought by some to be a happy one. It is widely assumed by both advocates and opponents of the Bureau that the infant agency will mark out a wide path for itself in the consumer financial protection field. The release by the Bureau of rules governing ''qualified'' mortgages and mortgage servicing requirements, for example, will have significant effects on the market.

The Bureau took its first enforcement actions beginning in July 2012 against Capital One Bank, Discover Bank, and American Express Bank. These orders imposed fines and mandated large refunds to credit card customers of the banking institutions relating to the sale of ''add-on'' products and other practices. The orders were issued jointly by the Bureau and the federal banking agency with primary responsibility for the banking institution. The future holds the promise of many more actions against bank and non-bank financial institutions.

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Even as the Bureau was in the process of being organized, significant enforcement actions were being mounted by traditional enforcement authorities against mortgage servicers and originators for their activities. In March of 2012 the Department of Justice and 49 state attorneys general entered into a $25 billion civil settlement arrangement with the five largest mortgage servicers, all banking institutions. The Federal Reserve Board also took enforcement action against the five institutions in conjunction with the joint federal-state settlement. Other large mortgage servicers are now negotiating with the Department of Justice and the state attorneys general to settle comparable civil claims for violations of federal and state law in the servicing and foreclosure areas.

In a separate but related enforcement process, the Federal Reserve Board and the Office of the Comptroller of the Currency in 2011 required the 14 largest mortgage servicers to retain independent consultants to conduct a comprehensive review of their mortgage foreclosures and to provide monetary compensation and other remediation for borrowers who suffered an identified financial injury in the foreclosure process. According to industry sources, the servicers have already spent in excess of $1.5 billion for the consultants' work with the prospect of another $2 to $3 billion to complete the review without a single dollar of compensation yet being paid to any aggrieved customer under the process. In the first week of January 2013, press stories emerged indicating that the Office of the Comptroller of the Currency was considering a comprehensive settlement in lieu of continuing the independent foreclosure review and financial remediation process. Ten of the 14 servicers subject to the comprehensive review program have now agreed to make $3.3 billion in direct payments to eligible customers and $5.2 billion in other assistance such as loan modifications or forgiveness of deficiency judgments available to customers. As word of the proposed settlement spread, a *New York Times* columnist wrote dismissively of the settlement, calling it ''another gift to the banks.'' Neither the regulators nor the regulated will get any credit for their efforts in this episode.

These settlements address only part of the mortgage problem, that relating to servicing and foreclosure practices. Other significant areas of exposure for mortgage

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originators and mortgage securities underwriters remain. One indicator of the possible range of liability is the fact that Bank of America Corporation has from 2010 through the third quarter of 2012 taken charges for litigation-related matters and other mortgage-related liabilities exceeding $35 billion. The sources of mortgage exposure from precrisis activities are manifold. In September 2011, for example, the Federal Housing Finance Agency on behalf of Fannie Mae and Freddie Mac sued 18 of the largest U.S. and foreign-based banks in connection with the sale of residential mortgage-backed securities to the two government sponsored enterprises. In October 2012 the New York State Attorney General filed a Martin Act lawsuit against JP Morgan Chase (as successor to Bear Stearns) relating to the sale of residential mortgage-backed securities by Bear Stearns to investors. This suit was the first action from the RMBS Working Group, a state-federal task force created earlier in 2012 to investigate alleged fraudulent practices in the sale of mortgage-backed securities. In November 2012, the New York State Attorney General filed a similar lawsuit against Credit Suisse, alleging investor losses from its misconduct.

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These actions represent only the most recent manifestation of claims arising from the origination and sale of mortgage-backed securities and other asset-backed securities in the run up to the financial crisis. The government investigations of pre-crisis activities and collateral private civil litigation show no signs of abating. The resolution of pre-crisis activities and other ''legacy'' issues will continue to occupy the banking sector for years to come. One of the first signs in the New Year was the announcement by Bank of America that it had reached an $11.6 billion settlement with Fannie Mae on mortgage repurchase and indemnification claims. Even as banking institutions strive to put ''legacy'' issues behind them, however, other exposures as in the LIBOR matter continue to accumulate. Announcements of law enforcement actions against other banking institutions are expected early in 2013.

## Conclusion

The authors of the Becker-Posner Blog seek to frame a discussion of the banking sector with their formulation of two questions. The first formulation: ''Is Banking Unusually Corrupt, and If So, Why?'' The second and only slightly more benign formulation: ''Is Banking Unusually Prone to Risky Activities?'' The authors of the blog indicate that they believe that the answer to each of these questions is ''yes.''

The heightened level of enforcement activity against banking institutions may suggest that the regulators and law enforcement authorities now subscribe to the same hypotheses as the Becker-Posner Blog. Alternatively, the heightened level of enforcement activity in the wake of the financial crisis may suggest that the regulators and law enforcement authorities are responding principally and reflexively to their perception of public expectations. In either case, the course of enforcement action is unlikely to change in the near future. Investigations of legacy issues still abound even as new issues as in the consumer area arise. The financial resources available to support these investigations will actually increase as a result of the record fines levied against various banks in 2012.

There are already reports of future regulatory enforcement actions in the anti-money laundering area targeting U.S. banking institutions and additional law enforcement actions targeting foreign-based institutions. Other law enforcement actions also appear to be imminent on the LIBOR front with Royal Bank of Scotland mentioned in the press as being close to reaching a settlement. The announcement in the first days of January 2013 of a guilty plea by Wegelin & Co., a Swiss private bank, which is closing its doors, to a felony count of conspiracy with U.S. persons to evade U.S. tax requirements is a fresh reminder of the ongoing pursuit of foreign banking institutions in this area. Press reports indicate that at least a dozen other Swiss banks are under investigation as well as several Israeli banks. Indictments have already been filed in the U.S. against several employees and former employees of other Swiss banks.

Last week both the Federal Reserve Board and the Office of the Comptroller of the Currency issued consent orders against JPMorgan Chase relating to deficiencies in anti-money laundering and sanctions law compliance systems and to deficiencies in risk management for certain trading activities(100 BBR 95, 1/15/13). A Financial Times editorial, noting that there was no admission of guilt and no fines imposed in connection with these orders, suggested that the approach of the U.S. regulators in these orders ″smells of protectionism″ when compared to the approach in recent enforcement orders against non-U.S. banks. It further opined that the orders ″fall short of what the public expects.″ This editorial confirms that press coverage of the banking sector in 2013 will continue to look to public perceptions for guidance on its opinions. In a display of robust corporate governance, the board of directors of JPMorgan Chase decided to make public an internal investigative report on the trading activities that were the subject of the regulatory consent orders and to reduce significantly the annual bonus of the firm's chief executive officer.

The effects of the heightened level of enforcement action in 2012 are already being felt in the banking industry. The critics of the law enforcement authorities in their use of deferred prosecution agreements and non-prosecution agreements have significantly underestimated the effects of these actions on the institutions and the senior management of the institutions. For many senior and mid-level managers these enforcement actions have in effect been career-ending. The demonstration effect on remaining management is certain to be substantial.

The critics of the use of these agreements also fail to appreciate another aspect of these agreements that has a disproportionate influence on management. This is the requirement (included in the enforcement orders for HSBC and Standard Chartered Bank) for an on-site monitor that reports to a government authority or a regulator. The prospect that an independent third-party will be scrutinizing on virtually a real-time basis significant operations of an institution, including senior management decisions in the area, cannot be anything but daunting to a management team imbued with a traditional view of its prerogatives. The ability of a third-party monitor to challenge the decisions of senior management by referring them to a law enforcement authority represents *real* punishment.

The critics also fail to accord appropriate weight to another feature of these enforcement actions that differs from traditional bank enforcement actions. Since at least the time of the Bankers Trust problems with Proctor & Gamble and Gibson Greetings in the early 1990s, the possibility of the disclosure of the damaging words of a representative of the institution on tape (or now on email) in civil litigation has led institutions to consider settling. This lesson was reprised in the enforcement context during the Spitzer era. The release of graphic email messages, as with the storied internal emails of security analyst Henry Blodget referring to securities he was recommending in scatological terms, was calculated to capture the public's imagination in a way that refined legal analysis could never hope to.

This experience has not been lost on other enforcement authorities. In its recent LIBOR enforcement actions, the Commodity Futures Trading Commission has quoted liberally from email and instant message texts. The factual statements incorporated into the recent deferred prosecution and non-prosecution agreements also avail themselves freely of the quotes from the institution's representatives. These agreements require the institution to admit responsibility for the conduct described in the factual statement and not make any public statement contradicting the contents of the factual statement. The combination of a deferred prosecution agreement or non-prosecution agreement with a factually detailed regulatory order addresses the concerns recently expressed by at least one court that regulatory settlements typically do not require the settling party to acknowledge responsibility and admit the charges made by the regulatory agency.

There is an important lesson here for all bank observers. Banking institutions must assume that even in a settlement with the law enforcement and regulatory authorities, the most incandescent emails will come to light, assuring damage to the institution and its management. It is now not enough to settle or settle early. It is imperative to avoid a situation where settlement might even become necessary. Recognition of this reality should provide a strong incentive for corporate management to invigorate compliance and control systems if only out of a concern for self-preservation.

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