JPMORGAN CHASE'S STACEY FRIEDMAN HAS A HUGE JOB AHEAD OF HER.

BY SUE REISINGER

BANKS 10, REGULATORS 0

The big banks have paid billions in penalties. But will the fines set them straight?

PHOTOGRAPH BY AXEL DUPEUX

BEFORE THE FINANCIAL CRISIS OF 2008, the banking industry had wallowed in the lack of regulation like happy hogs in a mudhole. Then Lehman Brothers Holdings Inc. went under, and the world's financial system was brought to its knees. Lawmakers passed the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to curb banking excesses. And suddenly Wall Street's world changed.

Regulators were empowered. They went after an array of offenses from "whale" trading to money laundering, from bid rigging to risky swaps practices. They levied record fines against the institutions—including some $6.5 billion collectively in the manipulation of LIBOR (the London Interbank Offered Rate) in 2014. Prosecutors even brought criminal charges against the world's largest and most prestigious banks—an almost unthinkable action before the crisis—for manipulating the world's foreign exchange market.

Five banks pleaded guilty and agreed to pay penalties. But there were few other consequences. The U.S. Securities and Exchange Commission agreed to let the five guilty banks continue business as usual, a decision that caused a rift at the agency. In a stinging dissent, Commissioner Kara Stein wrote, "Allowing

COVER STORY

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these institutions to continue business as usual, after multiple and serious regulatory and criminal violations, poses risks to investors and the American public that are being ignored."

The enforcement actions have spurred a fair amount of public debate over whether there are still too many banks that are too big to fail without bringing the world economic system down with them. So who's right?

We decided to take a broad look at the banking system five years after Dodd-Frank took effect. We found the bad bank beat goes on. This year, thanks to bank misconduct, federal enforcement officials are on pace to set a new record for the number of deferred prosecution or nonprosecution agreements signed in the first six months. Some 20 of 29 such agreements signed before July 1 belonged to banks. It is an era of hyper-regulation and global enforcement, of megafines and costly compliance requirements. Attorney Matthew Biben, a former general counsel of JPMorgan Chase & Co.'s consumer bank division and now a partner at Debevoise & Plimpton, calls the costly penalties "balance sheet justice."

But some regulators believe that enforcement efforts still aren't enough. Benjamin Lawsky, the former superintendent of financial services for New York, said in a speech just before he left office earlier this year that regulators face limited resources and are easily overwhelmed by the huge financial institutions they oversee, and by their massive law firms. "We will always run slightly behind them—it is just a matter of how far," said Lawsky, who at this writing was starting up his own legal consultancy firm.

Lawsky's frustrations spilled out in his speech. "It should come as little surprise then that we continue to see fraud, after fraud, after fraud on Wall Street," he said, "since the individuals who engaged in the wrongdoing rarely, if ever, face any real consequences."

JPMorgan Chase general counsel Stacey Friedman acknowledges the challenge. Friedman, GC in the investment division, was recently named to take over the bank's global top lawyer job early next year. In a July interview on her appointment, she said that she hoped to spend less time on the bank's "historic problems" and more on "preparing people to see the problems that can come up in the future so we can avoid them."

So will she get her wish, or will the scandals on Wall Street continue? Her former colleague, Biben, thinks the bad bank era is nearly over. "It's the fourth quarter of the fallout from the financial credit crisis," he says. "We are much closer to the end than the beginning."

BUT OTHER EXPERTS AREN'T SO SURE. Roger McCormick is managing director of the CCP Research Foundation in London, a visiting lecturer at the London School of Economics and a former partner at the U.K.-based law firm Freshfields Bruckhaus Deringer. McCormick expects the scandals to linger on. "Until we have an extended period, say three years, without major conduct scandals coming out of the woodwork," he says, "we cannot be confident that bank culture has turned the corner."

Recent news events support McCormick's pessimism. In June six global banks agreed to plead guilty to various criminal charges for fixing prices and rigging bids in the foreign exchange market. The six—Bank of America Corp. (BofA), Barclays, Citigroup Inc., JPMorgan Chase, the Royal Bank of Scotland and UBS—agreed to pay record criminal fines totaling $5.4 billion collectively. No bank would comment for this story.

June brought more bad news for the big banks. Federal regulators charged 36 financial institutions with violations in municipal bond offerings and levied civil money penalties against them. The same month the federal Office of the Comptroller of the Currency slapped new restrictions on mortgage operations at six banks for faulty foreclosure practices that they had been told to fix in 2011. The six—JPMorgan, Wells Fargo, Santander Bank, HSBC Holdings, U.S. Bank and Everbank—face new limits on their ability to obtain mortgage-servicing rights from other banks. Those rights allow big banks to "service" the mortgages of third-party lenders for a fee, by collecting mortgage payments and disseminating the money.

And that's not all. The U.S. Department of Justice named more than a dozen banks in its bribery indictment of nine officials of the Federation Internationale de Football Association, or FIFA, the governing body of international soccer. They include Bank of America Corp., Citigroup Inc. and JPMorgan Chase, as well as several British banks. The banks, which were not charged, allegedly were used to transfer cash as part of a $150 million bribery conspiracy. "Part of our investigation will look at the conduct of the financial institutions to see whether they were cognizant of the fact they were helping launder these bribe payments,"

MATT BIBEN CALLS THE FINES "BALANCE SHEET JUSTICE."

said Kelly Currie, acting U.S. attorney in Brooklyn, at a May news conference.

The collective cost of all this misconduct is nearly incalculable. But a project at McCormick's foundation in London is trying to put a price on it. The "Conduct Costs Project" found that the total legal cost of misconduct at the world's 16 largest banks surpassed $300 billion from 2010 to 2014. This year's multibillion-dollar penalties, and the litigation that is sure to follow, just add to the price tag.

U.S. banks did not fare well in the study. Three of the four international banks with the highest misconduct costs were BofA (No. 1) JPMorgan (2), and Citigroup (4). BofA had nearly twice the costs of JPMorgan, which itself had twice the costs of Lloyds Banking Group (3) and Citigroup, whose figures were very close. (See "Penalty Box")

Even McCormick concedes that the high costs have resulted in some radical business model changes. But so far he has seen no reason to expect 2016 to be devoid of banking scandals. "We are nowhere near that yet," he continues. "This sorry state of affairs seems set to continue for some time, while we are left wondering what next year's 'legacy issue' is going to be."

SEVERAL EXPERTS HAVE SUGGESTED ways to fix the banks. Most of them agree that higher fines are not the answer. Mark Taylor, dean of the Warwick Business School, said in an article published on CNBC's website in May that while the fines may have been embarrassing for the banks, they were "not that punitive for institutions with such deep pockets."

Taylor said the real issue is forcing a cultural shift. Prosecutors try to do this by requiring reform and compliance measures and sometimes imposing independent consultants, or monitors, on the financial institutions. But Taylor said that the U.S. needs to do more to move the financial sector away from a culture where "anything goes so long as you can get away with it" to one of trust and integrity. "It's not clear that corporate fines alone can do this," he added.

PENALTY BOX

Bank Name **Total legal costs, including contingencies (in billions of dollars), 2010-2014**

Bank Name	Total legal costs
Bank of America	$103B
JP Morgan Chase	$51B
Lloyds Banking Group	$24B
Citigroup	$23B
Barclays	$19B
RBS	$17B
Deutsche Bank	$15B
HSBC	$14B
BNP Paribas	$12B
Santander	$11B
Goldman Sachs	$10B
Credit Suisse	$9B
UBS	$8B
National Australia Bank Group	$4B
Standard Chartered Bank	$2B
Societe Generale	$1B
Total:	**$323 Billion**

Source: CCP Research Foundation

One solution may be holding individuals, not the banks, responsible for their actions.

That's especially true when the bank executives don't pay the fines out of their own pockets. "So company X pays a billion in fines," snorts Cornelius Hurley, director of the Boston University Center for Finance, Law & Policy. "It's no big deal because the managers don't suffer. The shareholders are the ones to pay." Hurley was formerly general counsel of Shawmut National Corp., a regional bank holding company, and assistant general counsel of the Board of Governors of the Federal Reserve System.

But what if criminal charges don't work either? Two years ago, Hurley says, "we thought it would be the end of the game for banks that plead guilty. But now they are so codependent with regulators that life just goes on" after a guilty plea.

He cited the SEC decision to let "bad actor" banks continue operating as usual. "If you aren't going to prosecute individuals, and criminal penalties on institutions don't matter anymore, what is the restraint?" Hurley wonders.

Then he answers his own question. "As long as they have the incentive to take risks where the shareholder picks up the pieces, whether those risks are legal or illegal, they will continue to take risks. I don't see any end in sight."

One key solution may be holding individuals, not the banks, accountable. Lawsky, noted that his former agency, New York's Department of Financial Services, has increasingly moved toward holding individuals responsible for bad behavior. "Simply having the right rules on the books is not enough if we are unwilling to enforce them effectively and aggressively," he said.

For example, Lawsky and New York state required the chief operating officer of France's largest bank, BNP Paribas, and the chairman of one of the United States' largest mortgage companies, Ocwen Financial, to step down as part of enforcement actions brought in 2014 against those companies. And the state banned several senior executives from participating in the operations of state-regulated financial institutions. Paribas pleaded guilty to handling transactions for sanctioned countries such as Cuba, Iran and the Sudan. Ocwen Financial entered a consent order citing violations of mortgage servicing laws and conflicts of interests. Both institutions agreed to keep independent monitors in place, but the most recent violations occurred despite both already having monitors because of previous violations—leading Lawsky to push for the individual penalties.

Biben sees prosecutors and companies wrestling with the question of individual accountability. "[Former New York Attorney General] Elliot Spitzer called for the resignation of CEOs and made directors reach into their own pockets [to pay penalties], agreeing not to seek indemnification," Biben says. "And it's hard not to wonder if the past will be prelude to the future."

JPMORGAN'S FRIEDMAN HAS HER OWN plan for fixing misconduct. She concedes that no one can promise that nothing will ever go wrong in a banking conglomerate as large as a city—Chase has some 260,000 employees. But she also cites research that says a very small percentage of problems stem from "bad actors." She adds: "That means 98 or 99 percent of the problems are caused by people who mean well."

And that means "we have to think about this much harder, at a level above the überconcept of 'Do the right thing.' We have to ask: How does this affect the consumer? Do our counterparties really understand the risks as we explained them?"

Another solution to bad actors may be more legislation. Boston University's Hurley favors a U.S. House bill to require so-called systemically important banks to pay a tax on being too big to fail. As he explains it, the money would be returned to the institutions, but they could not use it for anything but building their capital. "Going forward, that capital will become so large that there will be incentives for an institution to downsize itself and eliminate the perception that it is too big to fail," Hurley argues.

BENJAMIN LAWSKY, FORMERLY SUPERINTENDANT OF THE NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES

AP PHOTO/MIKE GROLL

The Federal Reserve had a different idea about capital. On July 20 it enacted new regulations requiring eight of the largest U.S. banks, including JPMorgan Chase and Citibank, to significantly increase their capital or reduce their size. Because capital is an expensive funding source for a bank, the new rule will force the banks to make a tough choice. As Janet Yellen, chairwoman of the Federal Reserve, said in a statement: "They must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system."

Other experts say what's really needed is more bank transparency. McCormick's Cost Conduct Project is proposing that banks present an annual "conduct costs report" as part of their annual reports. Project supporters say such transparency will help "to restore trust among investors and wider stakeholders."

But in the end, changes in technology may bring their own answer. Some experts say both sophisticated cybercrime and advancements in online transactions could accomplish what regulators and prosecutors so far haven't—convincing the institutions to downsize to a more manageable size. Experts suggest that big banks need to reduce size and shift resources to protect their core business from hackers.

Indeed, big banks are struggling with increasingly sophisticated cybercrime. In June, for example, federal prosecutors indicted a Turkish citizen known as "Segate" for allegedly organizing three worldwide cyberattacks that caused $55 million in losses on global financial institutions in mere hours. The attackers allegedly used sophisticated techniques to hack into the banking systems, steal prepaid debit card data and eliminate withdrawal limits.

New York state's Lawsky, for one, is deeply worried. His speech cited cyberterrorism as the most important issue that financial regulators face in 2015— and perhaps for years to come. "I am deeply worried that we are soon going to see a major cyberattack aimed at the financial system that is going to make all of us shudder. … We are concerned that within the next decade (or perhaps sooner) we will experience an Armageddon-type cyber event that causes a significant disruption in the financial system for a period of time—what some have termed a 'cyber 9/11.'"

The second big tech challenge for big banks has been tagged "FinTech." According to a recent report from the World Economic Forum and Deloitte Global, banks need to prepare themselves for a state of near-constant disruption as new technology helps smaller firms offer faster and cheaper financial services.

The report predicts the end of big, full-service banking. With that will come an era of increased specialization. Christopher Harvey, leader of Deloitte Global's financial services unit, said in a statement, "Global financial firms are operating in an increasingly disruptive environment, with new entrants and fierce competition becoming the norm."

Citing the report, Boston University's Hurley offers his own skeptical thoughts. "The big question in my mind," Hurley says, "is whether over the next five years the largest threat to the big banks comes from the disruptive effects of FinTech, or from their own ineptitude." ■