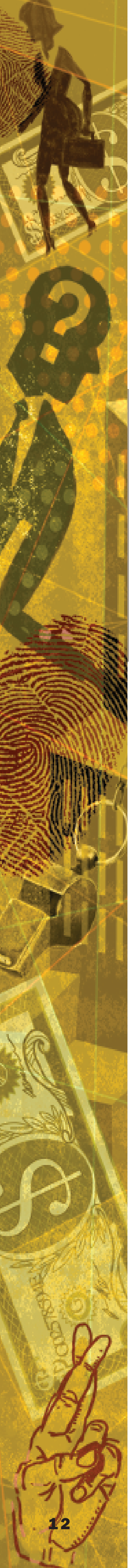

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Bank Controls Lacking, Regulation Insufficient

Significant losses by banks have shown the need for improved risk management and internal controls to avoid repeating past mistakes. To be successful, these changes require a stronger ethical culture, not more of the same regulatory actions that failed in the past.

You would expect the internal controls employed within the banking industry to be stronger and more effective than those in any other industry. After all, depositors trust that their funds held by the banks are always totally safe and readily available for withdrawal at any time. That's why banking institutions should have overarching objectives of good governance and effective control of risks, factors that depend on the strength of a bank's ethical culture, on avoiding conflicts of interest, and on minimizing the possibility of excessive self-serving risk taking. Recent announcements of huge losses by banks demonstrate that past regulatory efforts to ensure and attain these objectives have been ineffective and insufficient. What's needed is a stronger ethical climate.

In his Letter from the Chair in the *2011 Annual Report* of the Financial Stability Oversight Council (FSOC), Treasury Secretary Tim Geithner echoed the need for greater focus on ethical conduct by banks. The FSOC was created to analyze potential emerging threats to U.S. financial stability and recommend solutions. In his letter, Geithner said, "A stable financial system cannot be maintained by regulation and oversight alone. Those in positions of leadership in the financial sector will need to establish and maintain much higher standards for integrity and a more sophisticated understanding of the risk inherent in the business of finance than prevailed before and during this crisis."

To maintain an environment of trust for depositors, banking has become one of the most highly regulated industries. The Federal Reserve, Treasury Department, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller of the Currency (OCC) are among the federal organizations that provide direct oversight or auditing of almost every action a bank takes. Several regulatory agencies have adopted the strategy of housing bank examiners at the client bank's premises. The New York Federal Reserve Bank plans to have approximately 300 regulators embedded at the premises of banks in its geographic area of responsibility ("The Regulator Down the Hall," *The Wall Street Journal*, June 20, 2011). The OCC also deploys field examiners on site. You wonder how independent such personnel can be with only limited contact with their managerial supervisors while surrounded by client employees eager to convince the examiners of the virtues of all of the client's ways.

The reactions to past banking scandals have resulted in legislative remedies that were intended to prevent further massive losses resulting from fraud, greed, or just very poor judgment. For example, the savings and loan scandals of the 1980s resulted in passage of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Shortly thereafter, the cost of the many bailouts of institutions insured by the Federal Deposit Insurance Corporation resulted in passage of the FDIC Improvement Act of 1991 (FDICIA). Spurred by new mandates for enhanced safety and soundness, FDICIA initiated the rules that bank management must publicly assess—and independent auditors must attest to—the effectiveness of internal controls over financial reporting. This requirement was extended to all large publicly held companies by the Sarbanes-Oxley Act of 2002.

The financial crisis of 2007-2009 demonstrated the many inadequacies present in the regulatory environment of banks as well as in their risk management and internal control structures. Through the "too big to fail" doctrine, billions of taxpayers' dollars went toward emergency loan bailouts for banks to maintain their liquidity and avoid even greater catastrophe. In an extensive study of seven rescue programs, Bloomberg News reported that the massive amount of the Federal Reserve rescue effort reached a peak of $1.2 trillion and included many industrial and foreign as well as U.S. banks (Bradley Keoun and Phil Kuntz, "Wall Street Aristocracy Got $1.2 Trillion in Secret Loans," August 22, 2011). These efforts were "off-budget," and their extent was publicly unknown at the time. The many initiatives undertaken by the Federal Reserve include the Term Auction Facility (TAF), swaps, Commercial Paper Funding Facility (CPFF), Term Asset-Backed Securities Loan Facility (TALF), Temporary Liquidity Guarantee Program (TLGP), Transaction Account Guarantee Program (TAGP), and the Debt Guarantee Program (DGP). According to Bloomberg News, these programs were "almost three times the size of the U.S. federal budget deficit [in 2008] and more than the total earnings of all federally insured banks in the U.S. for the decade through 2010." New transparency laws adopted in 2010 require the Federal Reserve to disclose borrowers after two years.

The fallout and real costs of the financial crisis are still being assessed several years after the crisis. For example, *The Wall Street Journal* reported on June 30, 2011, that Bank of America NA (BAC) took a massive $20.6 billion loss provision. This amount represents settlement of claims of $8.5 billion by investors in mortgage-backed securities, $5.5 billion for similar settlements in the future, and $6.6 billion for lawsuits and a write-down of the value of its mortgage servicing business. This reverses all of the pretax earnings BAC reported since early 2007. Analysts are projecting that costs for similar sour mortgage securities claims will amount to about $9 billion for JP Morgan Chase and $4 billion for Wells Fargo. Recognition of these losses has resulted in the failure of many small and medium-size banks that weren't "too big to fail."

The aggregate amount of mortgage-related losses at Freddie Mac and Fannie Mae still haven't been revealed and could be considerable. In late 2009, these government-sponsored enterprises (GSEs) quietly received Christmas Eve gifts of "unlimited" financial aid and approval to continue growing their bloated portfolios of risky mortgage investments to $1.62 trillion. Because the federal government chose to accept only a 79.9% ownership stake in the GSEs in return for the "unlimited" bailout guarantee, it kept the financial results of these entities "off budget" so they continue to avoid Congressional scrutiny as part of the annual federal budget process. On September 1, 2011, *The New York Times* reported that the two GSEs had some $118 billion in shaky mortgage assets and planned to sue a dozen big banks for compensation for expected losses (Nelson D. Schwartz, "U.S. Is Set to Sue a Dozen Big Banks Over Mortgages").

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Geithner's letter in the FSOC *Annual Report* contains numerous disclaimers of why the regulatory approach adopted by the Dodd-Frank Act (DFA) may not be successful:

- "A significant number of independent agencies are responsible for specific aspects of the challenge of promoting financial stability…"
- "…identifying and mitigating potential threats to the stability of the financial system…is an inherently difficult exercise."
- "Actions taken to preemptively mitigate threats may appear at the time to be more dangerous than the problems they are designed to address."
- "We cannot predict the precise threats that may face the financial system."
- "We need to recognize that policy and regulation will often be behind the curve of innovation."

- “The challenge of maintaining a stable financial system is exacerbated by the difficulty of balancing the benefits of regulation against the costs of excessively restraining prudent risk-taking behavior.”
- “[Our approach] requires an ongoing focus on incentives within the financial system that might create or exacerbate vulnerabilities.”

But the most difficult task facing regulators—as well as the management and boards of directors of financial institutions—is the burden of more accurately measuring the nature of risks taken by individual firms and how these risks might affect the entire system. The financial crisis demonstrated how ineffective the credit rating agencies were in evaluating the quality of individual financial products. The DFA takes great pains in eliminating all of the legal requirements for banks to rely on credit ratings in assessing their safety and soundness, but the law doesn’t suggest any feasible alternative.

Because the financial services industry has vocally threatened to rescind major portions of DFA after the next general election, it’s too early to tell whether added regulation will truly be the answer to effective protection of the banking industry. It’s possible that these events could have been prevented had banks introduced improved risk management, better internal controls, and a stronger ethical culture. But does anyone know how to make sure such actions take place?

Warren Buffett has announced a $5 billion bailout of Bank of America. The real questions then seem to be: Is this sufficient for BAC, and are Buffett’s pockets deep enough to rescue other banks? As indicated by Secretary Geithner, ethical controls—such as increased integrity on the part of banking management—are required to truly ensure avoiding another round of huge losses in the future. **SF**

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