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Why Are Some Sectors (Ahem, Finance) So Scandal-Plagued?

By: Ben W. Heineman, Jr.

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In the past 25 years, the size of settlements, fines and penalties for individual corporations found guilty of wrongdoing has escalated from millions of dollars, to tens of millions, to hundreds of millions, to billions. Think Siemens and widespread bribery — about $2 billion. Or, bigger yet, think BP and the gulf disaster — almost $20 billion to date, with another $20 billion-plus likely in the future.

But during this period, there has been another change: highly expensive scandals *across business sectors*, not just in single companies, and this is reflected in the January 7th agreement by major banks to pay $8.5 billion due to derelict mortgage and foreclosure processes.

These sectoral scandals raise profound issues for business leaders: in a highly competitive global economy, in which some sectors are flooded with money, how do you assess sector-wide integrity risks and achieve a culture of corporate accountability *before*, not after, bad behavior occurs?

In the past, some multi-company problems have been due to introduction of a detailed regulation or to a change in enforcement policy. For example, application of complex financial accounting rule — FAS 133 relating to derivatives — led to expensive restatements in numerous businesses. The most notable was Fannie Mae's $10.8 billion restatement. In another instance, a new enforcement initiative — prohibitions against off-label marketing under the False Claims Act — swept through the pharmaceutical industry. The largest payments were from Pfizer ($2.3 billion) and GlaxoSmithKline ($3 billion).

But in recent years, there has been a series of striking scandals in the financial services industry that arose not out of complexity or changed enforcement, but from behavior clearly wrong or suspicious on its face. These financial sector problems are symbolized by recent, highly visible settlements.

Mortgage Improprieties. Bank of America, Citigroup, JP Morgan Chase, Wells Fargo and six other banks reached the settlement mentioned above to resolve allegations of foreclosure improprieties and bungled loan modifications by paying a total of $8.5 billion to homeowners. Other banks are considering whether to join the agreement (e.g. Ally Financial and HSBC Holdings). This pact follows a February 2012 agreement between B of A, Citi, JPM, Wells Fargo and Ally with State Attorneys General and federal authorities to pay $26 billion for similar failings. The announcement also occurred on the same day that Bank of America agreed to pay Fannie Mae $10 billion for bad loans it sold to the housing giant (part of efforts by Fannie and Freddie Mac to get refunds from other mortgage originators).

Money Laundering. A month ago, HSBC agreed with the Department of Justice, the Comptroller of the Currency and the Federal Reserve to pay $1.9 billion for money laundering ($1.3 billion forfeitures, $600,000 in civil penalties). The British bank was involved in hiding cash flows in two dramatic contexts: global drug trafficking (especially relating to Mexican drug cartels) and violations of economic sanctions against Iran and other nations associated with terrorism. The HSBC settlement was just the latest in a series of similar money laundering violations by at least a dozen financial institutions relating to illicit drugs or state sponsors of terrorism — e.g. ING Bank, Standard Chartered, Credit Suisse, American Express International — and involving settlements of tens or hundreds of millions of dollars per company.

LIBOR Rate-Rigging. In late December, a UBS Japanese subsidiary, in an agreement with the Justice Department, pled guilty to a crime in manipulating the London Interbank Offered Rate (LIBOR) and agreed to pay a $100 million fine. For its role in this burgeoning international banking scandal, the parent company, UBS AG, paid an additional $1.4 billion to other regulators in the U.S., Britain and Switzerland — more than three times the $451 million in fines imposed on Barclays, the first financial institution to admit fault in the LIBOR scandal last June. Two UBS employees were criminally charged. The rate-rigging involves both alleged fraudulent activity inside institutions and collusion between them (a possible antitrust violation). Major banks in the global financial system are under investigation because LIBOR rates are based on information provided by them, and JP Morgan Chase and Royal Bank of Scotland are among the institutions reported to be in settlement discussions. Because LIBOR affects as much as 500 trillion in financial products and transactions relating to such items as mortgage rates, credit card charges and student loans, culpable banks will face multi-billion dollar suits by private claimants in addition to multi-front government inquiries.

Said the head of DoJ's Criminal Division in the press release about UBS: "The scheme alleged is of epic scale, involving people who have walked the halls of some of the most powerful banks in the world."

These sectoral scandals have involved issues with serious societal consequences: injuring homeowners, supporting drug cartels and state sponsors of terrorism, rigging interest rates used in trillions of dollars of transactions across the globe. Generally speaking, these multi-company issues have arisen from bad acts by individuals in the middle of the organization and do not appear to have been directed from the top of the corporation. But the corporate consequences have been severe nonetheless: huge time and effort in investigating wrong-doing; large fines and penalties; forced entry into procrustean non-prosecution or deferred prosecution agreements; firings in the mid-ranks; CEO departures; clawbacks; serious reputational harm; and thus further erosion of trust in financial institutions, specifically, and corporations, generally. With respect to broad questions of business's role in society, the usual adverse impacts of corporate wrong-doing are multiplied in sectoral scandals.

Although books can be written about these multi-company scandals, there is one fundamental lesson for CEOs and boards of directors which requires heightened attention: *follow the money*. In all of these scandals, there has been a burgeoning honey-pot of funds which have tempted mid-level employees to cut corners dramatically in competitive businesses: billions (or trillions) in home loans, drug money or LIBOR rates.

For business leaders, the need truly to drive the fundamentals is at its height in such conditions: prevention through risk assessment of vulnerable processes, and effective risk mitigation through education and checks and balances; detection through internal reporting and internal forensic auditing; and early response before the problems metastasize.

But, the effectiveness of these fundamental steps turns ultimately on a corporate culture, led from the top, that puts integrity first. Such a culture was sorely absent in these sectoral scandals — and companies, business leaders and the corporate world in general have paid a stiff price. And, in the case of LIBOR rate-rigging, the story is far from over. As UBS CEO, Andrea Orcel, recently told Parliament: the financial industry has become “arrogant,” needed to overhaul its culture “to put integrity over profit” and try to recover the “honesty and standing of the past.”

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http://blogs.hbr.org/cs/2013/01/scandals_plague_sectors_not_ju.html