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Too Big to Manage: JP Morgan and the Mega Banks

By: Ben W. Heineman, Jr.
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Every casual reader of business news knows that JP Morgan Chase & Co. is in a world of legal hurt. But, it is not alone. Many other major financial institutions — Bank of America, Citigroup, HSBC, Barclay's, Wells Fargo, UBS, etc. — have their share of big dollar controversies with regulators and private claimants. The immediate news coverage is focused on the size of financial penalties for the institutions, on the potential civil or criminal culpability of bank officials and on the reputational harm to both the bank and its senior officers.

But the profound underlying question is whether these major financial institutions could have prevented the welter of business and related legal/accounting issues in the past and, more importantly, whether they can prevent such problems in the future. Of course, these institutions are always challenging aspects of regulatory regimes and engaging in disputes about future laws. But, at the end of the day, it is bank leaders and employees who must take the right business, legal and ethical actions under existing law. Are these huge major financial institutions not just too big to fail, their leaders "too big to jail" (as some critics charge), but also "too big to manage"?

The range of problems in the financial sector is striking: Bad trades with unforeseen and poorly understood billion dollar losses. Poor controls over risk and valuations. Deceptive communication within the company and to the board. Flawed mortgage origination, loan modification and debt collection practices. Manipulation of energy markets. LIBOR rate rigging. Participation in money laundering that helps drug smugglers or terrorists. Questionable hiring of sons and daughters of Chinese officials. Some of these problems occurred before the 2008 crisis and some since then. But they are not the regulatory esoterica that critics of Dodd-Frank worry about — if proven, these are core issues of wrong doing.

JP Morgan is the biggest of them all with $2.3 trillion in assets ,$1.1 trillion in deposits and approximately 260,000 employees, followed closely by Bank of America (also beset by myriad legal problems). CEO Jamie Dimon consistently espouses the virtues

of size and diversity. But, although profitable, JP Morgan has either settled, is settling, is being investigated for, or is in litigation about virtually all the issues noted immediately above and more, with consequences in the billions of dollars. Moreover, JP Morgan's legal expenses since 2008 have totaled more than $18 billion dollars (which does not include the enormous internal resources expended on these matters or the cost of settlements). Yes, JP Morgan is profitable, but it would be a stronger institution without these issues and all their complexities. The expenditure of time, alone, has been enormous.

Partly to calm the waters as it tries to navigate through its regulatory perfect storm, JP Morgan now states that it has no more important task than addressing its current legal issues and preventing them in the future. In his letter to shareholders in this year's Annual Report, Dimon said that "we are now making our control agenda priority #1." And, just days before the recent "London Whale" settlement with four different regulatory agencies was announced, Dimon wrote an anticipatory letter to employees reiterating the primacy of the control agenda and also announcing that the bank would add 5,000 employees in control functions (for a total of 15,000) and spend an additional $4 billion (1.5B on actual outlays and $2.5B in additional reserves). These letters followed a company task force report in January that sharply criticized many functions at many levels of the company for the "Whale" fiasco.

What, you may ask, is a control agenda? Its purpose is to prevent undue business risk, prevent violations of the spirit and letter of formal rules (financial and legal) and to prevent transgressions of global standards (ethics) which an organization imposes upon itself to enhance sound performance or to promote integrity. A control agenda seeks an irreducible minimum in harmful mistakes, gross negligence and bad intentional acts. It has three broad activities: to prevent, to detect and to respond. It must be led not by staff, but by business leaders who devote appropriate resources, hire outstanding people and embed the prevent, detect and respond activities deeply in business operations. These business leaders must, however, be aided by highly competent legal, financial, risk, compliance, audit and technology staff.

In a complex organization like JP Morgan, with many separate entities and lines of business, an effective "control agenda" is a huge undertaking. It means "process mapping" the myriad business functions; assessing business, legal and ethical risks at various points; mitigating that risk through education, checks and balances; and ensuring that problems are discovered early and handled promptly. It is a vexing, complicated task which requires both outstanding leadership and management. It also requires a significant investment of time and resources which, while sizeable, amounts to far less than the huge resource drain which scandal can cause. Ultimately, it means having an open, transparent performance-with-integrity culture that encourages but bounds business risk and that does not cut legal or ethical corners to make the numbers.

In his letters to shareholders and to employees, Dimon effectively admits that the bank had not properly addressed the broad set of control issues in the past, but he states clearly the effort required when the control agenda is a first priority:

"Adjusting to the new regulatory environment will require an enormous amount of time, effort and resources… We have reprioritized our major projects and initiatives, deployed massive new resources and refocused critical management time on this effort. We are ensuring that our systems, practices, controls, technology and, above all, culture meet the highest standards…Eventually most of these new processes will be embedded permanently in how we conduct our business."

One would expect a daily buffeting from regulators (and the media) to concentrate the mind, and so Dimon's words are hardly a surprise. Given the enormous management effort already devoted to the myriad issues, he and the board have clearly concluded that they cannot fight but must settle, if at all possible, and repair credibility and relationships with the regulators. And Dimon's strong words will no doubt be followed by detailed, complex actions — voluntarily adopted or required by government consent decrees — in a variety of areas: board oversight; risk management; internal audit of control processes; internal financial reporting and review; compliance with formal rules; education and training, etc.

But will JP Morgan's attempt to correct past, systemic control issues actually reduce mistakes to the irreducible minimum, the best one can hope for in so vast an institution? And will the intensity and focus of top management remain in 12 or 18 months when the current crisis has passed? Of even greater importance, will the JP Morgan example send a signal to other institutions regarding the necessary step function increase in resources, effort and leadership for an effective control agenda – and will that signal be received ?

One of the hardest corporate decisions is figuring out what level of resources to invest in prevention: the return is "avoidance" of catastrophic scandals (which can devour far more resources than the investment) and improved reputation with various constituencies. But these avoidance and reputational benefits are hard to quantify when set against real outlays for people, systems and processes. And that can stop needed control reform.

Ultimately, the issue of prevention is not about regulation. To be sure, a core set of regulations in an industry like finance is necessary and will always exist: to impose important internal processes, to set substantive standards, to require disclosure to the marketplace and to deter bad conduct both through the rules themselves and through enforcement. But all the rules in the world don't matter without strong CEO commitment, backed by the board, a culture of performance with integrity that is real and permeates the company, and the resources, people and processes to do the right kind of work — based on business reality not just rules — in all corners of the company.

The perils of JP Morgan, once esteemed as the best manager of risk among the elephants, reflects a bank that, in retrospect and by its own admission, does indeed appear to have been too big too manage. Whether the changes it is trying – or being forced — to make will more effectively prevent these kinds of business, legal and ethical problems in the future is, of course, uncertain. Whether its example will have preventative impact on other mega-banks is, of course, also unknown.

Whether these huge financial institutions are, in fact, too big too manage on this fundamental set of integrity issues will be one of the most important and intriguing business stories to follow in the years to come.

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