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BRIEFING

“Fines for misconduct in the banking sector – what is the situation in the EU?”

SUMMARY OF THREE EXPERT BRIEFINGS

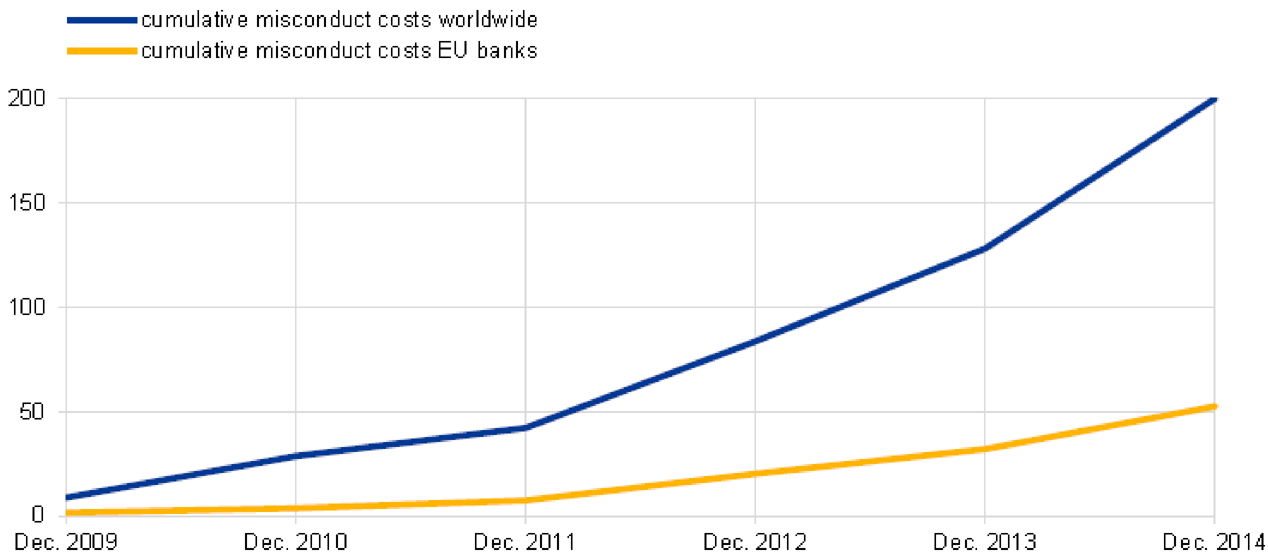
This note consolidates the summaries of three external briefing papers on “conduct risk” in the banking sector that were commissioned by the ECON committee and drafted by the members of the expert panel on banking supervision. This external briefings form part of the scrutiny of the Banking Union.

Background and relevance

Due to the number and scale of cases in which banks were in recent years fined for misconduct, namely for the wilful or intentional disregard of laws, ethics or internal governance and controls, that issue has a potential to create systemic risks in the banking sector; the European Systemic Risk Board (ESRB) already published a dedicated Report on misconduct risk in the banking sector back in 2015.

The ESRB indicated in a graph that over a recent five-year period, the sum of fines has increased significantly, reaching a cumulative total of around EUR 200 billion for all banks and EUR 50 billion for EU banks by the end of 2014.

Chart: Cumulative misconduct costs for banks from 2009 to 2014 (EUR billions)



Source: ESRB Report on misconduct risk in the banking sector in 2015, p 12 (based on data from the CCP Rsearch Foundation, Financial Times, Financial Conduct Authority).

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In view of the impact that those fines can have on banks' financial results, European Banking Authority (EBA) added the assessment of conduct risk as a compulsory element to the EU-wide stress test that was carried out in 2016. As reported in a previous EGOV briefing of 4 November, the information that EBA later on disclosed specifically on conduct risk was highly aggregated, just indicating that the aggregate cumulative conduct risk losses for the 51 banks participating in the EU-wide stress test would add up to EUR 71 billion over the three year period (which translated into a reduction of the average transitional CET1 capital ratio by 80 bps).

Given the importance of the topic and the limited information available, the ECON committee commissioned its panel of experts on banking supervision to analyse the situation in the EU in comparison to other relevant jurisdictions. The findings in the related **external briefing papers** can be summarised as follows:

Summary of the expert papers

Elena Carletti (Bocconi University and European University Institute) points out in her paper that in the US, the highest money penalties imposed on banks were not related to breaches of prudential supervisory requirements but to the mis-selling of financial products – a criminal offence falling under the remit of the Department of Justice.

Carletti finds that misconduct in the banking sector – despite its detrimental effects on both financial stability of the banking sector and the real economy – does not have a single legal definition. This makes addressing this risk particularly challenging in jurisdictions such as the US, where oversight and enforcement powers are distributed within a complex supervisory architecture repartitioning competences among numerous bank and activity-specific agencies. Even where a narrow definition of misconduct is adopted – that is the inappropriate supply of financial services – without adequate coordination, such complexity comes at the price of diluting enforcement action and exasperating informational asymmetries of the supervisor. The US experience shows that coordination and a holistic approach to the activities of banks is a precondition for an enforcement through money penalty regimes, in particular in cases of criminal bank misconduct such as fraud.

The US repartitions of oversight over the banking sector between various federal and state agencies, depends on the type of banking activity and the place of authorisation of the bank. In addition, the Department of Justice (DoJ) has played an essential role in enforcing rules related to misconduct through the imposition of money penalties for banks that have engaged in fraudulent activity over the course of the crisis.

By looking at the US legal framework as well as empirical evidence concerning the levels of fines imposed, Carletti's paper argues that the level of the fines in the US can be explained by the active pursuit by the DoJ of criminal misconduct, which sought further to overcome limitations stemming from a lack of adequate coordination by different bank supervisors.

The US system for addressing bank misconduct through fines delivers a number of lessons for the EU with regard to the design of bank enforcement architecture and the need to develop common approaches across national and EU levels to avoid regulatory arbitrage.

Martin R. Götz and Tobias H. Tröger (Research Center Sustainable Architecture for Finance in Europe (SAFE) and Goethe University) find in their paper that prudent banking regulation hinges on the ability of regulators to ensure that banks are stable and safe: The execution of enforcement action to correct deficiencies in banks' management and/or financial health is an important tool that allows supervisors to sanction banks in case they violate safe and sound banking practices and/or law.

Like Carletti, Götz and Tröger also compare the legal framework for supervisors in the Banking Union with the situation in the U.S. that governs the execution of enforcement actions against banks. However, they do not consider and examine liability based on criminal offenses in their in-depth analysis (which is included in Carletti's analysis) and rather focus on monetary penalties issued by supervisory authorities instead because European banking regulation does not provide for any sanctioning powers based on criminal offenses.

Consequently, Götz and Tröger analyse the legal provisions that allow imposing monetary penalties to sanction violations of prudential banking regulation (preconditions, range of fines) and observe no material variations with regard to typical misconduct. Important differences exist, however, with regard to the distribution of enforcement powers. While each supervisor in the U.S. has the independent authority to initiate enforcement actions and levy fines against the institutions that fall under its remit, the authority to execute enforcement actions in the Banking Union (SSM) is split between the European Central Bank (ECB) and national competent authorities (NCA).

Empirical evidence, mostly from the U.S., indicates that banks change their behaviour when they are subject to an enforcement action. In particular, existing studies highlight that banks become safer once regulators intervene. Regarding lending, other work has found that banks issue more favourable loan terms once they are subject to an enforcement action.

Detailed data on regulatory intervention in Europe is only scarcely publicly available; it is particularly inaccessible with regard to the ECB's practice. Götz and Tröger therefore focus on the evolution of enforcement actions by U.S. regulators. Their analysis indicates that U.S. regulators are quite active in sanctioning banks and issue on average about 500 enforcement actions against banks in the U.S. per year. The data also shows that the activity of U.S. regulators has increased since the financial crisis. Regarding the issuance of monetary penalties against banks in the U.S. they find that the aggregate amount of fines was very large in 2014 and 2015, where U.S. regulators issued total fines of more than 2 billion USD. This activity was primarily driven by monetary penalties against large banks in the U.S. due to wrongdoings in money laundering and their trading behaviour in foreign exchange markets.

Götz and Tröger conclude by focusing on the interplay between different supervisors regarding the execution of enforcement actions. To ensure that enforcement actions contribute to financial stability, it seems of utmost importance to them that supervisory authorities have adequate sanctioning powers at their disposal that allow them to react swiftly and effectively once relevant infringements of the regulatory framework are detected. Two things are particularly important. First, the regulatory framework has to allow that sanctions are set within the efficient range to correct social harm and serve as a deterrent and thus should not be truncated at suboptimal levels. Their analysis indicates that regulators in the Banking Union have the ability to set fines at efficient levels. Second, the procedure for imposing sanctions has to be practically workable. An inefficient overlap of competences of multiple agencies may compromise the incentive effects of enforcement actions. Regarding the Banking Union, it is important to note that the hub and spokes-approach of the SSM with its division of competences between the ECB and NCA provides an additional impediment to the effective sanctioning of banks. From their point of view, those shortcomings should not be neglected.

Andrea Resti **(Bocconi University)** finally focuses in his paper on empirical data that shows the situation in the EU. Based on public-domain figures collected by the CCP Research Foundation, Resti figures out that misconduct costs have been rising strongly for large European banks in 2011-2015, and end-2015 provisions show that the trend is expected to continue. Although no European lender matches the costs experienced by large US banks, several ones have crossed the EUR 10 bn threshold due to fines imposed in the US, including most large UK institutions, BNP Paribas and Deutsche Bank.

On the other hand, news on operational losses associated with conduct risk events that occurred in Europe (as collected by the ORX Association) suggest that the trend may have slowed down somewhat in 2015-2016. The distribution of losses looks highly skewed, with a few extreme cases associated with very high costs. More than 55% of the total costs originate from the provision of traditional banking services aimed at individuals, families and SMEs, like commercial banking and retail banking.

A drill-down exercise based on Italian data shows that – while large banks clearly generate stronger systemic risk due to their size – small and mid-sized institutions have experienced higher misconduct costs per unit of total assets. Additionally, banks that ended up requiring resolution or some other form of extraordinary support show a substantially higher incidence of conduct risk losses, even in the initial years, when most extraordinary interventions still had to materialize.

Resti also finds that less than a quarter of the EU's competent authorities have established dedicated teams or units on conduct risk, while slightly more than half include conduct risk in their supervisory examination programmes.

Resti warns that if fines and settlements simultaneously hit a large number of banks, originating systemic risks that may undermine the stability of the financial system. Furthermore, misconduct costs may be passed on to customers, or translate into job cuts and lower dividends paid out to shareholders (including retail investors). Hence, while ex post penalties clearly play a beneficial role, by discouraging inappropriate managerial choices and ensuring that past extra-profits are recuperated, they should from his point of view not be the main regulatory answer to banking misconduct. Other preventive tools should also be deployed, including:

- the improvement of the quality of bank governance,
- suitable remuneration schemes that condone inappropriate marketing practices, the use of whistle-blowing policies,
- and the improvement of the clarity of regulations to remove grey areas and discourage borderline practices.