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Banking: Litigation could seriously damage banks' health

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The costs of fighting legal battles at Countrywide increased 70% from 2005 to 2006, an early warning sign of the horrors to come. As litigation mounts, banks' expenditure to fight charges still attracts too little attention. Greater transparency could be one key to reform. Helen Avery reports.

LITIGATION IS A growing preoccupation in the financial industry. In its first-quarter report Goldman Sachs stated that the Commodity Futures Trading Commission was looking into filing against the firm's trade clearing unit for "aiding and abetting, civil fraud and supervision-related charges". It sounds serious. The possible charges relate to the extent to which the bank was aware that a brokerage operation was using customer accounts in transactions with Goldman Sachs rather than the firm's own accounts.

Allegations of aiding and abetting fraud are also being made against JPMorgan Chase. A case launched in February alleges that employees at JPMorgan were aware that Bernie

Madoff's investment fund was fraudulent, yet the firm continued to act as his commercial bank and invested client money into Madoff feeder funds.

On top of aiding and abetting in fraud, banks are being sued at every turn for foreclosing on homeowners improperly, for misrepresenting the quality of loans they were making to investors and insurers, and for betting against their clients. And the industry has turned against itself, with monoline insurers suing banks, and banks suing investment banks over CDOs.

"The mountain of cases is becoming an Everest," says Wes Christian, partner at law firm Christian, Smith and Jewell, who has prosecuted all the leading US banks.

Yet transparency about US bank litigation and the costs incurred to the banks of fighting it is limited. The extent to which each bank discloses costs incurred from litigation varies considerably, and is so confusing as to leave investors' heads spinning.

According to the SEC regulation, any public company need only disclose pending litigation costs that are deemed "material". A glance through bank 10k filings and disclosures of litigation reserve additions points to bank expenditure in the tens of billions of dollars. This seems very material. There has been some clamping down on lack of disclosure. Recent announcements of additions to litigation reserves were enforced by the SEC at the end of last year, for example. The SEC asked banks to state that, if there were a reasonable possibility of a litigation loss greater than that estimated in previous filings, the banks would have to disclose a range or a figure. That led to estimates of future mortgage-related litigation of almost $15 billion beyond established reserves. Yet those estimates apply only to mortgage-related losses, and even those estimates look unreliable. Is it not time that there was greater transparency surrounding bank litigation?

Does anyone know?

Precise figures on what banks are spending on legal fees as well as settlements and judgments on an annual basis are virtually impossible to uncover. Lawyers cannot tell you. Analysts do not know. The banks themselves seem confused. Of the top-four largest banks by assets, JPMorgan Chase seems to offer the most clarity. In a footnote on page 213 of its 10k filing for 2010, it states that the bank spent $7.4 billion in litigation expenses last year – up from $161 million in 2009. Yet a source at the firm says he is not entirely sure that the $7.4 billion figure includes monies expected to be devoured in future payouts also – so-called reserves.

Bank of America reports some of its legal expenditures but is more confusing. Buried in its 10k, it states: "Excluding fees paid to external legal service providers, a litigation-related expense of $2.6 billion was recognized in 2010," compared with $1 billion in 2009. Yet a spokesperson for the bank says that $2.6 billion was how much the bank had budgeted to pay out for future lawsuits, and did not include the $1.4 billion in legal fees that Bank of America chief legal officer Edward O'Keefe said, in an April investor presentation, the firm spent last year.

Citi offers no guidance at all in its 10k filing as to its costs, other than to highlight future potential losses, and a spokesperson at the firm was unforthcoming in offering backward-looking clarity around expenses. At Wells Fargo, the 2010 10k filing is equally opaque with regards to legal expenditure, although in its first-quarter report the bank disclosed an operating loss of $472 million from foreclosure-related litigation.

Goldman Sachs says its estimates for litigation reserves in 2010 were $682 million in a footnote regarding non-compensation expenses. At the firm's annual general meeting in April, Goldman Sachs's general counsel, Greg Palm, said it spent $726 million in 2010 on legal fees – 60% of which was spent on external lawyers. A spokesman at the firm says it does not report, however, how much was paid out in settlements and judgments in 2010 other than noting the $550 million settlement with the SEC last year within the $682 million. Morgan Stanley offers no figures at all.

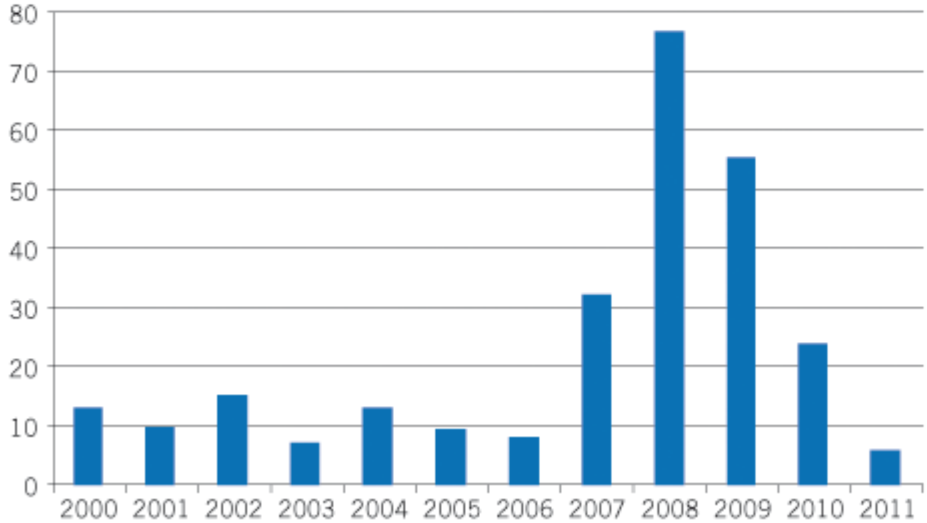
Why haven't bank investors or creditors addressed this obscurity about litigation costs? Perhaps because such costs, far from being extraordinary, are regarded as an inevitable drain on margins in an industry that preys on its own clients. Dick Bove, an analyst at Rochdale Securities, is blunt, and offers a somewhat depressing comparison. "People take banks as they do tobacco companies or asbestos companies. They know that the financial industry will have litigation costs, and no one has had to mention it so far, so why start now?"

Why start now? For one, if tens of billions of dollars are being spent, then one would think shareholders might like to know. Bove counters that so long as earnings growth is heading upwards, bank shareholders are unlikely to care. Increases in litigation, however, also point to something being awry. In the tobacco industry, for example, the prevalence of litigation shed light on the fact that the products being sold were not as harmless to health as consumers were led to believe.

Although there is no collective data that points to amounts of filings against banks historically, analysis by research firm Securities Class Action Services sheds some light. SCAS collates data on securities class actions filed against banks. In 2007, the number of cases filed was already 300% higher than in 2006. In 2008, as the financial crisis got fully under way, that figure jumped more than twofold again to 75 cases filed. While the current slew of litigation may be too late in preventing the past misdemeanours of the financial services industry, some research indicates that if a closer eye was kept on litigation costs at the banks, mounting problems could be detected earlier.

Filings against banks jump from 2007 onwards

Federal securities class actions filed against banks by filing year



Source: SCAS

Litigation a clue

James McNulty, a professor of finance at Florida Atlantic University, has been researching bank litigation for more than five years. He has presented to regulators evidence that suggests greater transparency on bank litigation is essential for weeding out misconduct. His research into litigation expenses reveals, for example, that there were inherent risks at Countrywide that would have raised red flags.

At Countrywide, non-interest expenses that included legal, consulting, accounting and auditing fees paid out rose steadily from $43.9 million in 2001 to $239 million in 2006. "Countrywide's litigation expense, measured by this proxy, increased by 70% from 2005 to 2006, rising from $141 million to $239.1 million," says McNulty. "No other institution registered such a large increase. If litigation expense were reported quarterly, the upward movement would probably have been apparent to regulators much sooner than the summer of 2007 when the sub-prime crisis enveloped financial markets. The FBI and the SEC did not start investigating Countrywide until 2008, but the red flags were already there had one taken a look at litigation expenses."

Following investigations, it has emerged that Countrywide had an aggressive sales culture that compensated its employees for making loans to customers that would not be able to afford to meet mortgage payments. Commission rates were as much as three times higher for sub-prime loans than for prime loans. Court case allegations filed by state attorneys general and community groups against Countrywide include extremely loose underwriting practices, charging improper fees, misleading people about hidden fees, inflating amounts owed and failing to keep accurate records of balances, attempting to obtain money and property from debtors under false pretences, filing inaccurate pleadings in bankruptcy court and other abuses of the bankruptcy system, and boarding up a home without a judgment or a court order when the homeowner was actually current on the loan.

McNulty argues that, had the increases in litigation expense since 2001 been considered and evaluated, bank regulators would have seen the allegations against Countrywide's loose mortgage practices earlier, and could have investigated what was happening at the firm sooner. "The bank examiners at the bank regulator, the Office of the Comptroller of the Currency, are required to address litigation claims with bank board directors, but it is not clear how seriously they take that." A spokesperson for the OCC said he was unable to say any more beyond the fact that the OCC does monitor pending litigation to determine risk of exposure, and that the regulator carries out regular updates.

McNulty argues that if litigation expenses were transparent, the OCC would see higher expenses that would alert them to asking more serious questions, and also be able to compare litigation expenses with a bank's peer group that would also alert them to compliance or corporate governance issues. "Some banks have six or seven times the litigation expenses of others as a proportion of their total assets according to my research. That is a clear indication that something is up," he says.

Peer-group comparisons based only on each bank's present disclosures provide little useful basis for making such judgements. That JPMorgan Chase reports $7.4 billion in litigation expenses, compared with Goldman Sachs's reporting of some $1.4 billion (of legal fees plus its SEC settlement and some reserves) comes with too little precise detail to offer any useful insight.

McNulty says that without this peer-group comparison, bank chief compliance officers themselves are unable to take a clear view on what practices might be in need of review at their own banks. Comparing costs among peers could indicate whether litigation is a result of internal failings, or failings of the industry at large. "If chief compliance officers themselves are not focusing attention on litigation, then lack of compliance slips through the net," says McNulty.

Michael Waldron, a regulatory and compliance lawyer at law firm Patton Boggs, agrees that litigation can provide a signal to banks that their operations need to be addressed. "It's helpful to monitor litigation to identify trends and then adjust operations to mitigate exposure," he says. He points out, though, that some complaints and claims are not legitimate. There is little barrier to entry on filing complaints after all. "Although even without substance, it would point to misconceptions in the industry that would be helpful to address," Waldron adds.

The reserve myth

Legally banks are only required to disclose "material pending costs" from litigation, and from an accounting perspective they have to report "probable losses where there is a reasonable possibility of a loss greater than estimated". It's vague to say the least. In response to some banks preferring not to go into the messy details, the SEC wrote to the largest financial services companies at the end of December last year asking them to give a number or a range of these probable losses with regards to reps and warranties. It has resulted in the announcement by banks of "additions to litigation reserves".

JPMorgan Chase is adding $4.5 billion. Citi says it expects $4 billion beyond its reserves. Wells Fargo expects $1.7 billion in losses above its reserves. Bank of America Merrill Lynch estimates $1.4 billion beyond its reserves in losses. Goldman Sachs estimates $2.7 billion in additional charges.

These estimates do not include all bank litigation, and do not include legal fees incurred. But the biggest enigma of all, it seems, is what are these current reserves to which the banks are now adding almost $15 billion? The answer might be surprising.

Bove at Rochdale Securities says: "There are no reserves. It's accounting fiction. There is no money set aside for lawsuits in a 'reserve'. These additions are just figures that accountants estimate and make a note of in a statement, and things get paid out as expenses are incurred."

Christian says the estimates themselves are worthless. "Accountants ask the lawyers to estimate the losses, but the defence lawyer is not going to say what the loss really will be, because he thinks the bank has no exposure. Worst-case scenarios are grossly deficient." Another lawyer on the defence side says that only those cases that are deemed large enough are considered by accountants to qualify for reserves. "Smaller cases made by individuals that are less than $1 million would typically not be considered," he says. One source at a bank argues their legitimacy. "Estimates on future settlements or lawsuits are accounted for in financial statements as they are recorded as a loss. So although no reserves are essentially put aside, the bank takes the hit ahead of time." But, he adds: "Estimates are likely to be unreliable as lawyers, of course, will temper even worst-case scenarios."

The banks have maintained that they do not want to disclose just how much they expect to pay out or have accounted for to pay out in losses as it gives prosecuting lawyers a figure to aim for in settlement claims.

Lawyer Max Kennerly at The Beasley Firm, however, says that is nonsense. "We know that banks have unlimited amounts of funds," he says. "Bringing a case against a bank is not an easy task in the first place. There is no shortage of bankers and economists who will say how complicated a case is. The banks have almost unlimited litigation reserves and can fight for years. The banks pay their lawyers by the hour, so those lawyers will go on forever if need be. Plaintiffs, however, do not get paid by the hour. The Department of Justice is publicly funded, so that too swings in favour of the banks. Knowing how much the banks are willing to pay out for all settlements would not disadvantage a bank in a lawsuit."

Settlements are not enough

One lawyer points out that settlements and funds paid out through legal losses are of little consequence: "Payouts now are too little too late. If many of the allegations are true against the banks, they will have made much more from the alleged activities than they will have to pay out in legal fees and settlements. It's not enough to hit them with hefty fines or payouts. These cases need to be made transparent so that the causes of the wrongdoing can be addressed."

Jerry Silk, a senior partner at law firm Bernstein Litowitz Berger & Grossmann (BLB&G), says the financial services industry has always been at the centre of scandal. His law firm ranks top in the US for settlement values for 2010, winning almost $1 billion in settlements in securities class action suits, and is now representing several prominent financial institutions including TIAA-CREF Life Insurance Company, New York Life Insurance Company, Dexia Holdings, and Thrivent Financial for Lutherans in connection with their purchases of Countrywide mortgage-backed securities. "When you think back to the days of Enron and WorldCom, the investment banks were there at the scene of the crime, whether they were accused of being complicit or a gatekeeper that fell asleep on the job. The story is ongoing. Despite what we believe to be an egregious course of conduct in transparency, fiduciary duty and compliance with the law, the banks seem to be repeat offenders," says Silk.

In several of the settlement cases BLB&G has won, it has tried to impose corporate governance reform as part of the settlement terms. Pharmaceuticals firm Pfizer is one such case. For illegally marketing many of its bestselling drugs, Pfizer was subject to a $2.3 billion fine from the US Department of Justice, the largest criminal fine ever imposed for any matter and the largest civil healthcare fraud settlement in history. In response to this management failure, BLB&G led a shareholder action against the Pfizer board and its officers and obtained a settlement under which defendants agreed to create a new regulatory and compliance committee of the Pfizer board supported by a dedicated $75 million fund to oversee and monitor Pfizer's compliance and drug marketing practices.

The settlement also provides for the establishment of an Ombudsman Program as an alternative channel to address employee concerns about legal or regulatory issues.

"Settlements are misleading. Being hit with a $500 million fine is nothing if the bank made 20 times that much from that action"

Wes Christian, Christian, Smith and Jewell

Such changes in corporate governance in bank settlements might be more helpful than monetary settlements alone. Indeed, settlements do not necessarily address criminal activity within a bank. When a bank settles a lawsuit with the SEC or government, the details of the allegations are opaque. "Essentially when a bank settles with the SEC, it is not admitting to any wrongdoing," says

Silk. So, for example, Goldman Sachs did not admit to wrongdoing when it settled SEC securities fraud charges for $550 million despite the fact that the bank admitted that its marketing materials for a mortgage-linked security contained incomplete information. Christian at Christian, Smith and Jewell says: "Settlements are misleading. Being hit with a $500 million fine is nothing if the bank made 20 times that much from that action. The fine is one specific transaction and that releases the banks from being questioned on all the other transactions."

There has, however, been some pushback on simply allowing banks to settle without further investigation into the allegations, says Silk. Several federal judges are now saying that they will not rubber stamp a simple fine but want to know exactly what happened. For instance, federal judge Jed Rakoff criticized the SEC’s $33 million initial proposed settlement with Bank of America to resolve charges that the bank failed to disclose critical information to investors in connection with its acquisition of Merrill Lynch. Rakoff characterized the settlement as "misguided," "inadequate" and failing to "comport with the most elementary notions of justice and morality". He only reluctantly approved the SEC’s revised $150 million settlement, explaining that it was "paltry" in nature and "while better than nothing, [was] half-baked justice at best".

Will this wave of litigation lead to greater reform on Wall Street? Anthony Laura, a bank litigation defence lawyer at Patton Boggs, says that litigation has had the impact of "bringing greater diligence and accountability by lenders and servicers, and many players have already shown renewed commitment to that". His colleague, Waldron, says litigation is at the forefront of the minds of boardroom executives down to floor-level operators at banks. "Legislation is coming, but for now the regulatory agencies and attorneys general are reforming the industry through enforcement. Litigation is very impactful but the banks are limited to what they can address publicly."

Banks’ litigation costs are rising	
Additions to litigation reserves, mortgage-related ($bln)	
JPMorgan	**4.5**
Citi	**4**
Goldman Sachs	**2.7**
Wells Fargo	**1.7**
Bank of America Merrill Lynch	**1.4**
Source: Bank disclosures	
Litigation expense disclosure not uniform	
Total litigation expenses as disclosed 2010 ($bln)	
JPMorgan	**7.4**
Bank of America Merrill Lynch	**4**

Goldman Sachs	**1.4**
Citi	**not stated**
Morgan Stanley	**not stated**
Wells Fargo	**not stated**
Source: Bank 10k filings, Euromoney	

Christian says the costs do not go unnoticed at the banks. "External lawyers can cost $800 to $1,000 an hour, and they send three in at a time. All the bank defendants in a case will spend in the aggregate $50 million to $100 million. Investment banks will have to try to manage their fiduciary risk better as litigation costs are becoming enormous."

A further deterrent to poor corporate governance at banks is what has become as one lawyer puts it "the elephant in the room". No one is going to prison. Kennerly says: "It seems very odd that someone steals $500 from a gas station and goes to prison, yet there have been few, if any, criminal prosecutions in this round of litigation." Silk adds: "Where has the government been in terms of criminal penalties? There has been a real reluctance to hold senior management accountable, and we've not seen many if any criminal prosecutions arise from the mortgage crisis and credit crisis".

That might be about to change. A report in the *Wall Street Journal* in May claimed that the SEC was pushing to bring charges against individuals involved in selling CDOs and other mortgage-related products. One lawyer, who wishes to remain anonymous, is candid: "We need transparency around bank litigation, we need tighter regulation and oversight, but sadly not until someone is seen being dragged away in handcuffs will the public really feel that the judicial and regulatory system has a grip on bank misconduct."

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