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Regulators Size Up Wall Street, With Worry

By PETER EAVIS

Money laundering, market rigging, tax dodging, selling faulty financial products, trampling homeowner rights and rampant risk-taking — these are some of the sins that big banks have committed in recent years.

Now, some government authorities are publicly questioning whether such misdeeds are not just the work of a few bad actors, but rather a flaw that runs through the fabric of the banking industry.

After years of saying little about the behavior of bankers, even as one scandal followed another, regulators are starting to ask: Is there something rotten in bank culture?

It is a concern recently voiced by William C. Dudley, president of the Federal Reserve Bank of New York, the institution that has more day-to-day contact with Wall Street than any other arm of the government.

"There is evidence of deep-seated cultural and ethical failures at many large financial institutions," Mr. Dudley said in a speech that sent a chill through the financial industry last year.

In a recent interview, Mr. Dudley explained why he decided to make such a loaded point about bank culture: "To make it clear that 'too big to fail' isn't the only problem," he said in his office three blocks from the actual Wall Street in Lower Manhattan. "I don't want senior bank management to feel, 'Oh gee, if we solve "too big to fail," we're done.' "

"Too big to fail" refers to the belief that some banks are so large that if they got into trouble, the government would have to rescue them to prevent their failure from harming the wider economy. Congress and government authorities have taken many steps to put banks on a firmer financial footing, but such efforts do not focus on cleaning up the ethics of large companies.

The regulators, however, may find it hard to convince the public that they mean business. Such sweeping pronouncements were not made after the financial crisis of 2008, which exposed the recklessness of bankers.

But as new scandals occur, bank regulators may feel that they have to take to the bully pulpit to make critical pronouncements about the ethos of the industry that they monitor.

“I think that they really do have a serious issue with the public,” Mr. Dudley said of the banks. “And I think that trust issue is of their own doing — they have done it to themselves.”

Other senior regulators are speaking out in a similar vein. Thomas J. Curry, the head of the Office of the Comptroller of the Currency, has recently devoted several speeches to cleaning up the culture of banks. In a recent interview, he gave some insight into how his agency sometimes views its relationship with the banks.

“It is not going to work if we approach it from a lawyerly standpoint,” Mr. Curry said. “It is more like a priest-penitent relationship.”

“This is a perfectly sensible response to what they have encountered,” said Barney Frank, the former congressman who was a co-sponsor of the sweeping overhaul of the financial system known as the Dodd-Frank Act. “You have a sense of frustration.”

At the heart of the issue is an inviolate social contract that bankers are supposed to honor. The government agrees to protect banks from collapse, and in return, bankers are meant to uphold the highest ethics when handling other people’s money.

But when lawbreaking and other missteps proliferate at banks, it is a sign that the industry has stopped cleaving to the special contract, endangering taxpayers. And bad management can be a leading indicator of future financial problems at an institution. “It usually translates into losses down the road,” Mr. Curry said.

The big question is whether regulators have the resolve to back up their tough words with meaningful punishments. Banks, for instance, have armies of lawyers who deploy strategies like refusing to turn over potential evidence to regulators. And the largest banks make such big profits these days that they can easily absorb the financial penalties the government throws at them. Also, notably, top bank executives did not voice their support for Mr. Dudley after he gave his sharply worded speech on culture.

“I haven’t yet seen bankers rushing to say Bill Dudley speaks truth on this issue,” Cornelius K. Hurley, a professor at the Boston University School of Law, said.

Nonetheless, there are some signs that financial regulators have become more assertive since the financial crisis. The Office of the Comptroller of the Currency and the New York Fed, which each had a reputation for being too soft on the banks, have made important changes.

The regulators say that they have taken important steps since the crisis that will make it easier to crack down when they need to. Mr. Curry pointed to some new rules that his agency proposed in mid-January that, he said, could facilitate enforcement when rules are broken. “We are ratcheting up the potential consequences,” he said. “This is something new.”

The regulators also said that they have stepped up pressure on the banks’ boards. The regulators hope that more independent-minded directors will demand changes if they see standards and practices slipping, especially in crucial areas like accounting and risk management. To help promote that push, Mr. Dudley said, the New York Fed has bolstered the stature of supervisors who interact with the boards and senior executives. “We’ve put some of our very best people in those spots,” he said.

But boards may have very different priorities from regulators. Directors may not see the need for far-reaching changes if a bank is producing large profits that benefit shareholders.

JPMorgan Chase’s board took steps to hold management accountable after the so-called London Whale trading scandal that engulfed the bank in 2012 and 2013. Still, in January, JPMorgan’s board approved a large raise in the 2013 pay of Jamie Dimon, the bank’s chief executive.

Antony P. Jenkins, the chief executive of Barclays, which has been hit by its own scandals, took a different approach with his 2013 compensation. Earlier this year, he turned down a bonus worth $4.5 million.

And compensation is one area where bank regulators may need to do more if they want to do more to clean up bank culture, according to critics of the industry.

Wall Street's compensation practices can reward unhealthy levels of short-term risk-taking and entice bankers into ethical lapses. Acknowledging that, regulators around the world agreed after the crisis to overhaul bankers' pay, in part by requiring them to wait several years before they receive all of their bonuses. The hope is that bankers will behave better if they know their employers can easily take back the deferred part of their pay.

But there is evidence that large American banks are still deferring much less pay than their European peers. The Fed is in charge of regulating compensation at American banks. When asked whether the pay overhaul at American banks had gone far enough, Mr. Dudley said, "There is potential to defer more compensation for longer periods of time."

One particularly daunting challenge looms over the efforts to improve the ethics of banks. Some banks may be so large and complex that it would be difficult for managers to maintain a clean culture across all of their operations.

But Mr. Dudley said he would not allow size or complexity to be an excuse for ethical breaches. "Either the firm is not too complex, you can manage it, you do know what's going on," he said. "Or, if you don't know, that's sort of raising the question whether the firm is too complex to manage."