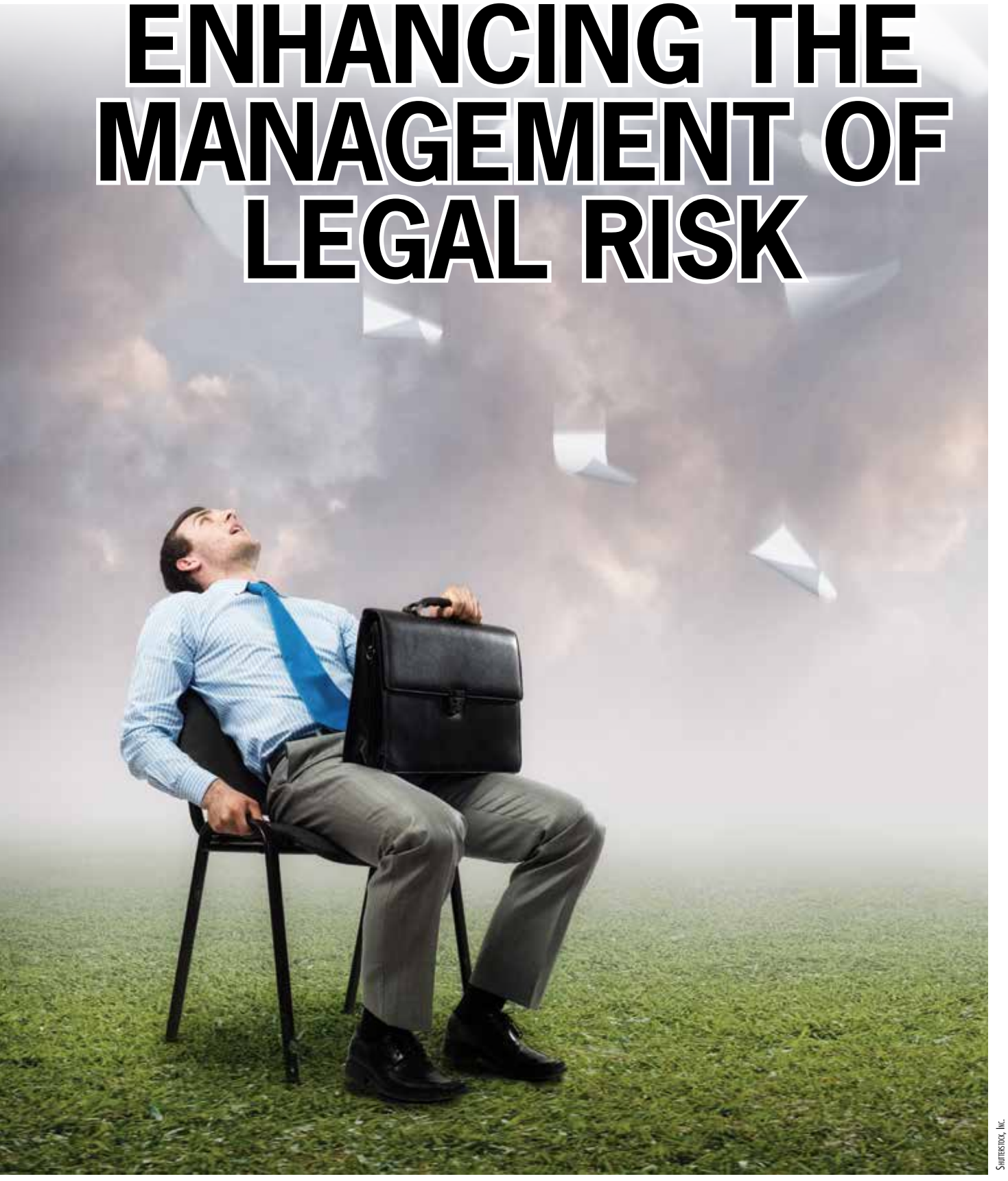
ENHANCING THE MANAGEMENT OF LEGAL RISK



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RELYING SOLELY ON GAAP, OR EVEN CCAR, REQUIREMENTS TO ADDRESS LEGAL RISK MAY MEAN AN INSUFFICIENT CAPITAL CUSHION TO COVER UNEXPECTED LOSSES.

BY JEFFREY F. INGBER

A REGULATED FINANCIAL institution is required to appropriately identify, measure, monitor, and manage all of its risks and to hold assets sufficient for it to continue operating as a going concern if potential losses materialize.

Indeed, one of the requirements in the Dodd-Frank Act is that every bank holding company with $10 billion or more in assets must have a risk committee, composed in part of independent directors and at least one risk management expert, that is "responsible for the oversight of the enterprise-wide risk management practices" of the firm.

Last decade's financial crisis exposed the inadequacy of the risk management systems of many banks. In the ensuing years, much progress has been made in addressing deficiencies in capital, liquidity, market, and credit risk management.

A different type of risk, one that has not received nearly the same degree of attention, is legal risk. For a regulated financial firm, it can arise from sources including civil litigation, an enforcement action by a federal or state regulator, or criminal action by a prosecutor.

Legal risk traditionally has been considered a type of operational risk—the risk of loss from inadequate or failed internal processes, people, and systems or from external events. It can constitute a large majority of a bank's overall operational risk. Indeed, legal risk is placed in the Basel II Accord under the operational risk umbrella and is defined to include, but not be limited to, "exposure to fines, penalties, or punitive damages resulting from supervisory actions as well as private settlements."

In the Federal Reserve's annual Comprehensive Capital Analysis and Review (CCAR) exercise, legal risk is typically encapsulated in the Clients, Products, and Business Practice category, which essentially is the means by which it is included in the overall operational risk capital calculation.

Legal risk is age-old, and firms have become comfortable with the established processes of identifying and managing it. However, the current legal risk environment is particularly difficult—one that is more critical than ever to assess and address. This article reviews the reasons for this environment, the problems that arise in dealing with legal risk, and a potential range of mitigants.

IN RECENT YEARS, FINANCIAL FIRMS, PARTICULARLY LARGER ONES THAT DO BUSINESS IN MULTIPLE JURISDICTIONS, HAVE BEEN FACED WITH CIRCUMSTANCES THAT HAVE INTENSIFIED THE CONCERNS ABOUT LEGAL RISK AND MADE IT MORE DIFFICULT TO ESTIMATE EMERGING LEGAL RISK EXPOSURE.

The Need for Increased Focus on Legal Risk Management

In recent years, financial firms, particularly larger ones that do business in multiple jurisdictions, have been faced with circumstances that have intensified the concerns about legal risk and made it more difficult to estimate emerging legal risk exposure.

First, there are the increasing costs of resolving cases brought by governmental entities such as prosecutors and regulators, including the subsequent need to extensively remediate control deficiencies, hire additional staff, and increase technology spending. Large supervisory fines and penalties pose significant risk to firms' capital, earnings, and overall financial positions.[1] As the saying goes, "It's not what you make, it's what you keep."

Meanwhile, fundamental changes and additions in the regulatory environment resulting from Dodd-Frank (such as the creation of the Consumer Financial Protection Bureau and the requirements of the Volcker Rule) have increased the risk of misinterpreting or inadvertently violating statutes and regulations. Interpretation of new legal requirements must be done in an atmosphere of heightened public, media, and political concern about financial institutions and their ethical cultures.

Moreover, there has been a policy shift among federal and state prosecutors and supervisors to increasingly require financial institutions to admit wrongdoing, and criminal prosecution now is a more likely outcome of corporate misdeeds. This is a significant departure from the former common practice of "neither admit nor deny" settlements and exposes firms to increased legal exposure due to the greater likelihood of lawsuits. It also may impact the firms' right to conduct certain business activities (in other words, if needed waivers from government regulators are not obtained).[2]

Finally, it is widely speculated that global financial institutions may face increased liability from anti-money-laundering civil litigation arising from a case in September 2014. For the first time, private litigants used an anti-terrorism statute to hold a financial institution liable for the consequences of transactions the bank processed, even though that bank claimed to have followed all required sanctions and screening procedures for designated terrorist organizations.[3]

In January 2015, the Office of the Comptroller of the Currency (OCC), in the Legal Matters section of its *Safety and Soundness Handbook*, laid out its expectations for how a bank should control litigation and mitigate its impact. (While the OCC has jurisdiction only over national banks, its approach may reflect that of other supervisors.) Among the highlights of the OCC's guidance are that a bank should 1) establish a culture of ethical standards and ensure that compensation systems are aligned with risk management objectives; 2) develop written policies for monitoring and managing litigation; 3) maintain adequate capital or specific contingency reserves to cover potential judgments or settlements; 4) implement systems and controls to ensure compliance with applicable legal requirements; 5) implement training programs and internal control processes to identify, limit, and manage litigation exposure; 6) seek necessary legal advice and assistance; and 7) oversee and monitor any outsourcing of or third-party arrangements for legal service.

Several of these elements, such as policies, training, internal controls, and third-party monitoring (which is extremely burdensome and difficult to get right for larger banks), are standard fundamentals of a comprehensive compliance and risk management program. The first item cited—ethical culture and appropriate compensation schemes—is significant in that it reflects a post-crisis emphasis on these matters by supervisors globally. The third item, legal reserves and capital, is discussed below.

Legal Risk Management: Key Considerations and Concerns

1. The Limitations of GAAP Accounting Requirements as a Risk Mitigant

Balance sheet reserves are the first means by which firms absorb litigation losses, with capital an additional line of defense. With regard to pending litigation, Statement of Financial Accounting Standards (SFAS) No. 5, Accounting for Contingencies, provides that a potential loss resulting from pending litigation must be accrued and recorded when it is "probable that one or more future events will occur confirming the fact of the loss" and when "the amount of the loss can be reasonably estimated." Typically, this accrual is referred to as a firm's legal reserve, as in the accounting world when a reserve is considered a loss contingency.

If a firm determines that one or both of these conditions have not been met, SFAS No. 5 requires it to disclose loss contingency when "there is at least a reasonable possibility that a loss…may have occurred." This disclosure "shall give an estimate of the possible loss or range of loss or state that such an estimate cannot be made." (As noted by the Securities and Exchange Commission's deputy chief accountant in 2004, it is often the case that zero is considered the low end of a range because no other number is more likely until a settlement is negotiated.)

When the litigation is finished, the resulting settlement or judgment is then disclosed and recorded in that period. Establishing a reserve for general contingencies, which would promote the ability of a bank to protect itself from litigation risk based on historical precedent, is not allowed by GAAP.

As a practical matter, firms and their internal and external counsel, in considering the existence of material and substantive defenses and other mitigants, have wide discretion in determining whether the loss contingency is probable, reasonably possible, or remote. The lawyers' analyses and judgment are critical, and no exact formula exists in most instances. Rational differences in judgment can occur regarding similar fact patterns, potentially raising the perception of managing earnings. In particular, once it is determined that a loss is probable, setting the actual reserve amount involves considerable judgment, including determinations such as whether and to what extent there are material and substantive defenses and other mitigating factors.

The key is that, however difficult it may be to set a timely and reasonable legal reserve amount, the bank must try to do so using past precedent and the facts of the current case, within the context of an established process that contains standards to be evaluated and adhered to (more about this in the next section). As we know, many factors—such as litigation outcomes, supervisory or prosecutorial judgments, the political environment, and bad internal decisions—cannot be controlled. What can be controlled by a bank are its internal reserve-setting processes, which should be made as proactive, value additive, and forward-looking as possible.

The combination of significant judgment being involved in setting legal reserves and the fact that GAAP requirements are a disclosure standard, not a prudential one, means that legal reserve amounts may be an inadequate measure for assessing the likelihood, timing, and magnitude of potential losses and their impact on capital, liquidity, reputation, and market confidence.

Thus, another key consideration in this arena is recognizing that relying solely on GAAP requirements (or even CCAR ones, for differing reasons such as its limited time frame) to address legal risk may lead to an insufficient capital cushion for covering unexpectedly large losses.

2. Diverse Practices for Setting Legal Reserves

Yet another problem with gaining comfort from a firm's legal reserving process is that there is no standard set of best practices. Key variables that should be considered include the following:

- Sufficiently detailed implementing procedures for the legal reserving policy.
- Strong corporate governance oversight over the reserving process, which may include a central committee to review and oversee the setting of legal reserves, reporting to the

board of directors on a regular basis on reserves, and required approval of the board for reserves greater than a certain threshold.
- The breadth and consistency of matters included within the definition of "legal losses."
- Extent of the use of modeling to project legal losses, combined with active use of a management/expert-judgment overlay.
- The manner in which the firm estimates the growth trajectory of a case, with proper recognition of the lag between the date of awareness of potential litigation and the final settlement.
- Degree of consideration of peer litigation and industry trends to inform reserve estimates.
- Frequency of evaluation of reserves (more frequently than quarterly), especially when the firm is engaged in matters that could be resolved in the near term.
- The vibrancy of the level of review and challenge of reserve practices and amounts by the audit committee and outside auditors.
- Availability of documentation on the decision-making process for auditors and others.

In sum, banks can vary significantly in the vibrancy of their reserve-setting processes, which can have substantial impacts on the amounts ultimately set. The key to getting this right is to establish a rigorous and thoughtful process that is consistently applied and is actively overseen by senior management.

3. Absence of Appropriate Back Testing

A bank may wish to consider the active use of back testing its past reserving practices against ultimate payouts. This can inform and enhance a firm's assessment of how well its processes set legal reserves, in terms of both timing and amount.

More specifically, a strong method of verifying legal reserving practices is for a firm to continuously assess its history of 1) starting the reserving process early enough; 2) establishing a dollar amount of reserves sufficient to cover the final settlement; 3) establishing that level of reserves well in advance of the date of settlement; and 4) adjusting reserves suitably as more precise estimates of final settlement amount become available. Of particular concern is avoiding cases of large loss where a significant "top up" of the reserve occurs in the quarter immediately preceding the quarter of settlement, or in the quarter of settlement itself.

A simple mathematical tool can be developed as a representation of a firm's historical reserving efficiency, based on factors such as completeness of reserve, timing of initial reserve amount and subsequent revisions, size of settlement or judgment, and application of additional capital. This tool can facilitate through quantification a bank's ability to assess how well it has, over a period of time, sufficiently covered settlement amounts through the reserving process before the settlements are paid out.

4. Reliance on Capital as a Tool

Beyond provisions to cover expected losses, firms set aside capital to cover unexpected (or extraordinary) losses, which may include legal ones. While the subject of using capital for risk management purposes is beyond the scope of this article, it should be noted, as cautions, that 1) capital does not take the place of liquidity; 2) capital may not cure a lack of confidence in a bank; 3) capital may create an illusion of risk protection; and 4), notably, legal risk is difficult to measure and cannot be well calibrated to a capital mitigant. Thus, having a

strong capital cushion is no substitute for a vibrant process that is designed to prevent and manage legal risk.

5. Limited Role of the Legal Department

Lawyers play a key role in a bank's operation in many ways, including as key partners of the CEO and senior management team, as enablers of business outcomes, as trusted advisors, and as guardians of the company's interests. A bank's in-house lawyers also need to take on additional "nontraditional" roles that may be seen as conflicting with the above ones, such as acting as a strong, independent control function and as risk managers (which may lead them to act as a needed temper to certain business opportunities).

In other words, lawyers must find the right balance between helping the business "get to yes" and telling the business, "No, this is not an appropriate product, service, or transaction." Lawyers should not limit themselves to addressing matters strictly in the legal domain, but rather should play a proactive role in preserving a firm's reputational and ethical culture (which is particularly important in an environment in which banks are looked upon unfavorably by a wide segment of the public, media, and legislators); in integrating lessons learned from actual and potential crises and scandals; and in having a meaningful "seat at the table."

6. Interaction with Supervisors

It is critical for banks not only to assess and manage all of their key risks but also to communicate adequately with their supervisors about such management, including significant pending litigation changes and potential new litigation. Indeed, the OCC stated in its 2015 guidance regarding legal risk that examiners are expected to know about any significant pending or potential litigation against the bank; to obtain a list of any such litigation; and to consider whether management has effectively managed the litigation process.

Frequent and proactive communication with bank supervisors in a meaningful manner (as opposed to colorful anecdotes and data dumps) includes being frank, disclosing the bank's key concerns, and demonstrating to the supervisors a thoughtful legal risk management process. This will go a long way toward providing supervisors with a sense of comfort and avoid any second-guessing on their part.

7. Tension between Financial Reporting and Defending the Bank's Interests

A bank's counsel also must be careful to weigh the need to provide sufficient disclosure with the need to protect the company from disclosing information that may be harmful to its position in the ongoing litigation. Attorneys need to avoid disclosure of information to financial officers, accountants, analysts, etc. in a manner that waives the attorney-client privilege or releases information protected by the work product doctrine.

In its guidance, the OCC asks examiners to determine, based on information received from the bank and its counsel, whether a lawsuit raises significant legal or policy issues within the scope of the OCC's supervisory responsibility, such as the proper interpretation of federal banking laws. While encouraging its examiners to obtain the needed information from sources that are not privileged, the OCC acknowledges that there may be instances when access to privileged materials is considered necessary.

In such cases, bank counsel should work closely with the examiner and the OCC's legal counsel to evaluate how best to obtain the information. Finding the right balance in this regard allows a bank to maintain credibility with its supervisors while not giving the appearance of abusing the privilege.

Conclusion

This is not your grandmother's legal risk environment, and it requires significant additional focus. Here are some key issues and questions to consider:

- The scope of the bank's definition of "legal risk" (for example, does it include reputational risk?).
- Is it managed as part of the bank's overall risk management strategy?
- Additional best practices to bring to the process of setting legal reserves.
- How capital might be used as a supplement.
- The breadth of the role of the legal department, including ensuring it has a sufficient "seat at the table" and provides an appropriate level of independent challenge.
- The bank's legal risk appetite and whether it should be formally defined.
- Ensuring that all parts of the business are sufficiently involved in identifying legal risk and considering lessons learned.
- Legal's role in the approval process for new or modified products, services, transactions, third-party relationships, and other strategic decisions.
- The extent and quality of communication with supervisors regarding legal risk. Ⓡ

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Notes

1. According to the Boston Consulting Group, U.S. and European banks paid nearly $65 billion in penalties and fines in 2014, about 40% more than in 2013, when the previous high was recorded.
2. For example, it was publicly reported in May 2015 that Credit Suisse had quietly withdrawn a request for a WKSI waiver to raise capital more easily, after SEC staffers told the bank it would not win approval.
3. On September 22, 2014, a Brooklyn jury held an international bank civilly liable under the Anti-Terrorism Act for facilitating the financing of terrorism. *Linde v. Arab Bank PLC* is the first case in which private litigants have used the anti-terrorism statute to hold a financial institution liable for the consequences of transactions the bank processed legally.