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Statement of the Shadow Financial Regulatory Committee on

The JPMorgan Settlement

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The recent $13 billion settlement between the JPMorgan Chase and a number of federal and state agencies drew unusual editorial reactions, among others, from the Washington Post, Wall Street Journal and the Economist. All three criticized the government for creating what the Economist called “a culture of fear.” Without exculpating the bank from its role in the financial crisis, the editorialists noted that the government’s effort to exact severe punishment overturned “basic principles of justice” in the words of the Washington Post.

The Shadow Committee is similarly troubled by several elements of this episode.

First, it is well-known that financial institutions like banks are subject to pervasive supervisory power. Because they depend on customer, creditor or depositor belief in their fundamental integrity, they can ill afford to litigate with their supervisors. Banks are thus in a weak position to contest charges with a government that refuses to settle other than on its own terms. This in itself calls into question whether the size of a settlement is an indication of the seriousness of the charges and the strength of the government’s case, or simply the result of the government’s overwhelming power.

Second, this is compounded by a lack of transparency. The rule of law requires that the government act only against violations of specific rules, and reveal and support the facts on which its charges are brought. In the JPMorgan case, for example, all we have are a series of allegations, with little or no indication of what evidence the government was relying on. Of the $13 billion settlement, $4 billion
was to go to the Federal Housing Finance Agency for alleged losses suffered by Fannie Mae and Freddie Mac in buying private mortgage backed securities from JPMorgan Chase or two firms it had acquired—Washington Mutual and Bear Stearns. To say the least, it is difficult to believe that the financial sophisticated and highly paid officers of Fannie and Freddie were unaware of the borrower risks inherent in the subprime mortgages they were buying primarily to comply with the government’s affordable housing goals. In what way were the securities sold by JPMorgan or its predecessors worse than the mortgages or mortgage-backed securities that Fannie and Freddie were expecting to get? We don’t know, and there is no way to pierce the settlement to find out. This lack of transparency adds to the suspicion that settlements between banks and the government are not arms-length outcomes in which each party weighed its options and risks. As noted above, there is a sense that the bank ultimately had to agree to whatever the government wanted.

Third, JPMorgan has also been required to pay fines of over $1 billion to various government agencies for the so-called “Whale” losses, but the legal basis for some of these fines is unclear. Unnamed government officials have told the press that JPMorgan misled them about this transaction, but again the evidence for this is lacking. If regulators were misled, what were the circumstances? On the substance of the Whale transaction, if the employee involved was acting outside his authority, as has been alleged, then it is not clear why the bank—a victim—should pay a fine. If there was a failure to supervise the employee, what are the facts? If the employee was acting with the knowledge of the bank’s management and used bad judgment in the trades he was making, the fact that the bank suffered a $6 billion loss would appear to give it sufficient incentive to address the management problem that occurred, without causing the shareholders an additional loss through a payment to the government. If the bank had violated a law or regulation, what was it? For example, the $100 million fine JPMorgan recently paid to the CFTC, was imposed because the bank had dumped “a gargantuan, record-setting, volume of swaps virtually all at once, recklessly ignoring the obvious dangers to legitimate pricing forces.” The CFTC called this a “manipulative device” a vague concept. Once again, it appears as though the government was piling on, taking advantage of an opportunity to force another eye-catching settlement on a bank.

Fourth, the government’s actions have adverse implications for the future. A substantial part of the $13 billion settlement amount was attributable to actions by Bear Stearns and Washington Mutual, two firms that JPMorgan acquired at the behest of the government. The effect of charging JPMorgan for the bad conduct of institutions the government wanted the bank to acquire will certainly chill the willingness of healthy firms in the future to acquire failing firms when the government thinks this is desirable.

Finally, through the charges against and mammoth settlement with JPMorgan Chase, the government has sent a troubling signal to the private sector. The large number of government actions against the bank began after Jamie Dimon, the chairman of the bank, had publicly criticized the administration over the Dodd-Frank Act and had also criticized the government’s regulatory policies. This may suggest to private sector firms that they risk retaliation if they criticize the government or its policies. If this is the implication, it would be destructive for both our economy and our political system.