The Distant Sound of Drums:
The Compliance Challenges After Privacy and Predatory Lending

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It’s a pleasure to be here this morning before so distinguished an audience of senior compliance officers. I do think that you have the hardest job in the bank. You’ve got the responsibility to fix some of the industry’s most sensitive problems, but you often have to do so without all the authority you need — let alone the resources. You and your staffs get a lot of attention when things go wrong — the trick, of course, is to get it to help things to stay right.

Indeed, all too often individual institutions or the industry in general gets into trouble because emerging problems are overlooked until they grow so large that quiet resolution becomes quite difficult. It’s a sorry truth of human nature that it’s easier to get attention when you’re bleeding than when you’re just coming into harm’s way.

In this talk, I would like to highlight a few areas that I think could be as problematic to the industry as privacy and predatory lending have proven to be. In fact, I think privacy and predatory lending are in some ways precursors to these new issues. Like them, these new concerns will be resolved one way if the industry takes them seriously now and quite another — and far less forgiving way — if the issues are ignored until the press and Congress get interested in them.

I am a big believer in self-regulation and voluntary codes of conduct. It’s amazing how convincing these are even in the most dire circumstances. I’m referring here, of course, to airline travel. None of you needs me to tell you that business travel has become a non-stop trial, with the airlines’ broken promises compounded by their missed timetables, non-existent food and surly service. When the nicest thing one can say about air travel is that the airplanes don’t crash much, you know it’s time for a consumer revolt. Somehow, though, it doesn’t happen and this is in large part the result of an escalating series of voluntary codes of conduct the airlines have adopted to mollify the traveling public and the Members of Congress that represent them.

So, if it can work for the airlines, self-regulation surely can work for the financial services industry. The trick is getting a credible — although the airlines’ example suggests that perhaps even this isn’t necessary — plan out before the outcry becomes so loud that no self-regulation will do. It’s too late for voluntary codes to do much about privacy and predatory lending, but let’s take a look at a couple of other issues where they might still do a great deal of good for the industry and its customers.

The E-Challenge

Obviously, electronic delivery is one of the most exciting areas in the industry now. Although customers are taking to on-line delivery far more slowly than all of the boosterism of a year or so ago suggested, there is a clear and inexorable trend towards the use of the Internet as an alternative way for consumers to learn about and acquire financial services.

To date, most of the industry’s attention has been on facilitating e-finance — that is, getting rid of the cumbersome paper-based requirements intended for an earlier age. Last year, Congress addressed this problem with sweeping legislation, and the Fed is now moving forward with implementing regulations that should (in general) make it easier to offer consumer financial products over the Net.

But, as the barriers go down, some new obstacles are arising. I am most concerned about the hyperlinks to third-party sites. I agree with the bank regulators that some institutions have not carefully vetted these third-party sites and cannot vouch for their practices even as they send their customers clicking on into cyber-space. This is, I think, bad business judgment, since a customer made unhappy through a referral is a customer likely to take his or her business elsewhere altogether. It does, however, also pose a regulatory question: do the regulatory protections afforded when a customer deals with a bank apply when they move on to do business with someone a bank recommends? Is it clear to the customer when a new vendor is involved in the seamless transition from web site to web site?

I have the same concern about aggregators. The Fed is considering declaring them “financial institutions” under Reg E, but it has yet to do so. Most customers likely think that an aggregator is a financial institution with all the attendant regulatory liability protection, but they are wrong. So far, this distinction doesn’t make much difference, in part because customers have been slow to use aggregators. However, it will make a lot of difference as aggregators advance from providing simple information services to actually handling transactions. Customers now have no protection if an aggregator bungles a funds transfer, and I very much doubt that anyone using these services knows this.

I would note that there is an industry effort going forward to establish best practices for aggregators, and I commend this. It’s a great start on getting ahead of a problem, and I hope more institutions join with this and other efforts to address the growing compliance challenges of on-line finance.

Disclosures Don’t Do it

A response to the concerns outlined above is that customers know who’s who because they receive disclosures stating when they are dealing with a bank and when they aren’t. I have strong doubts about this. First, let’s not be too sure about all these disclosures. Your banks may well be providing clear and conspicuous ones, but that’s no guarantee that other institutions are doing so. This is particularly worrisome with new entrants into the industry. Some on-line banks – not to mention a few others – have been established by entrepreneurs with little understanding and less respect for the three-ring binders full of rules by which all of you live. Entering banking from far less regulated industries, they bridle at being slowed down by a set of standards they think absurd, and they focus instead on effective marketing.

However, I'm not at all sure that – even if every financial institution were providing all the requisite disclosures – this would be sufficient to allay consumer concern about who they are dealing with and how much liability protection they have. One lesson we are learning is that disclosures don't matter. Consumers don't read them and, when they do, they often don't understand them. This message is coming through loud and clear with the privacy notices in the mail. As an article in Sunday's *Washington Post* indicated, many of these notices are very hard to read. The fact that only about five percent of customers are opting out tells me not that customers aren't concerned about privacy, but that most of them aren't reading or don't understand the disclosures they are getting.

This is even more clearly the case with the disclosures provided on mortgage transactions. Giving customers all the disclosures in the world can't erase the fact that some loan terms are abusive. Why don't customers understand this? Sometimes, of course, the customers are being victimized, but even when they aren't it can be very difficult to understand the many conditions applicable in a first or second mortgage.

There has been a lot of talk about TILA and RESPA reform, but so far no action. The industry and consumer groups remain at loggerheads about how to simplify the blizzard of paper that falls on the mortgage borrower, and Congress has so far shown little interest in intervening to settle this dispute. There is nothing that stops the industry from providing consumers with additional clear and simple disclosures that detail the few critical terms of a financial transaction, and from doing so verbally. Until the law changes, this additional disclosure will unfortunately be just one more piece of paper, since lenders cannot omit any of the many legally required forms and statements. However, lenders that provide customers – and I'm not just talking now about mortgage borrowers – with simple, clear and fair descriptions of their terms and conditions will not only be doing their customers a service, but also leading the way towards a more rational disclosure framework that could permit far more effective marketing of financial services.

Taking on Tying

Let me move now from retail to wholesale banking. I don't think it was an accident last week that the papers were full of virtually identical articles about big banks pushing out big investment firms in the lucrative IPO business. The *New York Times* and *Wall Street Journal* each had pieces that looked as if they had been written off the same press release, unusual in such scrupulous newspapers. What was the point of these stories, and the similar ones that have appeared in many other high-profile sources in recent weeks? One point is that big banks are using their lending power to demand more profitable M&A and underwriting business, pushing out the traditional investment banks that can't or won't provide loans to large corporate customers. But that's only one aspect of this growing story.

There's nothing wrong with big banks rolling over investment banks in the hurly-burly of Wall Street competition. Indeed, bulge-bracket investment banks are not likely to evoke the sympathy on Capitol Hill accorded victims of predatory lending bamboozled by dubious lenders. Most folks think the likes of Goldman Sachs and Merrill Lynch can take care of themselves. And so they can, but not if they allege that big banks are illegally tying the services they want to sell to their corporate customers to those – namely loans – that these same customers have to have. Tying is illegal whether it's done when a mortgage loan is made conditional on the purchase of credit life or if it's done for a Fortune 500 customer told that it can only get a loan if it commits to giving the bank its corporate advisory work.

It's clear to me that the investment banks are readying a legal challenge against their big bank competitors that will have a strong political component to it. To avoid the embarrassment of Capital Hill hearings and a lot of adverse publicity, the industry should make sure now that its practices will stand up to public scrutiny. Beating the competition is all well and good when it's done on the up and up, and that's the point that will need proving in the very near future.

Capital Conundrum

Finally, I would like to draw your attention to the proposed new risk-based capital rules released in early January by the Basel Committee on Banking Supervision. For those of you with responsibility for ensuring that your banks comply with the capital rules, these proposals warrant careful scrutiny. To date, they haven't received much attention, although I think the new standards could be a major shock when finalized unless they are dramatically changed from the Basel Committee's most recent proposal.

Time does not permit a detailed discussion of the new proposal. It is intended to make the capital standards align more closely with the real risk profile of a bank, eliminating the wide differences between economic and regulatory capital that now permit institutions to arbitrage their capital positions. However, the new rules are very complex and are based on an array of regulatory assumptions. As a result, they will impose a significantly higher capital requirement on most institutions. Small banks might end up exempted from them, but they will then be covered by a separate capital standard with the same – higher – bottom line.

One reason the new capital rules result in higher capital is that they include a new capital charge for "operational" risk. That is the risk of systems or human errors – including legal ones like violations of the fair lending laws or the rules against employment discrimination. If these rules go into effect, the compliance function will be tied into the capital allocation one in a new, and I think highly inappropriate, fashion.

The Basel Committee has decided to leave other risks – interest-rate risk, for example – under the "supervisory" pillar of the new accord. This means that banks would strive to meet best-practices standards with regard to these risks, and then supervisors would ensure that this was in fact actually being done. It is essential that operational risk also fall under this supervisory approach. If not, banks will find themselves subject to very high capital charges on their asset management, custody and payments processing activities, making it hard to compete with non-bank providers of similar services.

In this talk, I've very briefly outlined four areas where I think banks face new and onerous regulation:

- in electronic banking, where customers are being confused about which services they are using and how aggregators work;
- in the overall area of consumer disclosures, which more and more confuse customers, not help them;
- in wholesale banking, where significant concerns are being raised about tying; and
- in the capital rules, which could be very, very costly.

One of Washington's axioms is that you can't beat something with nothing. In all of these cases, and several others we haven't had time to discuss, the industry will not persuade Congress and the public by sitting on its hands. All of the problems here are real ones, so doing nothing isn't an option. There have been some excellent efforts in improving industry practices in a number of areas, but I don't think these have gone far enough or been widely enough accepted to gain the credibility a true self-regulatory campaign requires.

One last thought – it's not good enough to agree on voluntary standards a day or two before Congress takes a hard look at an industry problem. The securities industry learned this last week when it issued a voluntary code of conduct on analyst integrity two days before hard-hitting house hearing. The code was widely derided in the press as a last-minute effort to thwart criticism, and it got a very harsh reaction at last week's hearing. Good-faith effort that it was, it cut far less ice than it should have.
I started this morning by pointing to your major responsibilities to ensure that each of your bank's meets and exceeds the many standards set for it. I am ending by adding a new one to your list: providing senior management with strategic counsel that identifies emerging compliance issues and suggests changes that don't just solve a specific problem with a new bank-wide form or another mandate in the internal rule-book. No one is in as good a position as you to counsel senior management and the industry as a whole about the concerns you see, nor is anyone as well qualified to suggest a forward-looking solution that accommodates the bank's marketing and business needs yet recognizes customer concerns. In my view, this is the real compliance challenge. Those of you who embrace it will, I think, do your banks and the industry as a whole a tremendous service.