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Compliance Challenges in a New Regulatory Era

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This article will examine a decade long compliance explosion, analyze the latest problems presented by a focal change to consumer protection and explore the significant bank compliance issues and frustrations wrought by regulatory changes. In short, this article will examine how compliance has moved from a distinct, complementary group to an integral part of nearly every bank operational, lending, training, security, privacy, audit and risk management decision.

Compliance in the Days of Yore

While important, until a decade ago, compliance had a discrete function analyzing laws, regulations, regulatory guidance and case law, drafting forms and notices, preparing memoranda and policy recommendations for executive officer and board of director use, assisting with employee compliance training, approving marketing and advertising materials, positioning required notices, insuring the accurate maintenance and compilation of data, and drafting compliance reports for and meeting with regulators during examinations. While the foregoing is an impressive list of responsibilities, compliance was a smaller and slower world then.

In the span of about twenty-five years, the following major statutes and concomitant regulations were enacted (years referenced are effective dates):

- Truth in Lending Act of 1968 ("TILA");[1]
- Bank Secrecy Act of 1970 ("BSA");[2]
- Fair Credit Reporting Act ("FCRA");[3]
- Equal Credit Opportunity ("ECOA") of 1975;[4]
- Real Estate Settlement and Procedures Acts of 1975 ("RESPA");[5]
- Home Mortgage Disclosure Act of 1976 ("HMDA");[6]
- Community Reinvestment Act of 1977 ("CRA");[7]
- Right to Financial Privacy of 1979 ("RFPA");[8]
- Electronic Funds Transfer Acts of 1979 ("EFTA");[9]
- Money Laundering Control Act of 1986 ("MLCA")[10]
- Expedited Funds Availability Act of 1988 ("EFAA")[11] and
- Truth in Savings Act of 1991 ("TISA").[12]

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It was common for statutory effective dates to occur more than a year after passage to allow for comprehensive regulation drafting and bank implementation. Most early compliance laws provided meaningful disclosures allowing "apple to apple" comparison of financial products or insuring that banking transactions would be handled in identical matters nationwide. BSA and MLCA were limited law enforcement tools tempered by the RFPA's extension of constitutional principles of an "expectation of privacy" and from unreasonable intrusions from the **federal government** to a customer's bank transactions. ECOA accomplished an extension of non-discrimination laws to the lending world.

In 1995, I drafted my first deposit agreement. I was an Associate General Counsel for one of the then 100 largest banks in the country. The agreement spanned eighteen pages in booklet form, measuring less than 8" x 4" (a materially lengthier edition than its sixteen page predecessor). The merger of our two state banks into a national bank necessitated the revision. Compliance issues comprised half of the agreement including disclosures required by EFAA, TISA, and EFTA plus some basic information on privacy and third party information sharing (although, with regard to the two latter issues, prudence, and not regulation, dictated inclusion). There were but two cross-references in the agreement to augmenting documents —a signature card and a schedule of fees. Over the next few years, I also worked on revisions to numerous policy and procedure manuals. The manuals provided thorough compliance guidance; however the compliance section was, to be generous, a small portion of each manual. Of course compliance reports were provided to regulators and regular compliance exams occurred.

Today, it is not unusual to find deposit agreements extending sixty full-sized pages exclusive of privacy, information sharing and other notices. Far more than half of a typical deposit agreement is devoted to core compliance issues. Policy and procedure manuals multiplied and lengthened as well as the compliance sections contained therein. The typical home mortgage compliance documents exploded from a few sheets to a small binder. The amount of regulatory reporting increased exponentially (a list of the report acronyms would easily fill half the page). Exams grew concomitantly longer. Legions of compliance consultants and software providers flourished to help manage compliance issues. However, as described further, this is only the visible portion of the iceberg. To understand how compliance became so deeply ingrained in core financial institution decisions, an examination of the forces of change and regulatory counter-measures is necessary.

GLB Ushers in a New Compliance Age

The cause, or at least the start, of the compliance explosion began in 1999, due to the passage of the Financial Services Modernization Act, colloquially named Gramm-Leach-Bliley ("GLB").[13] GLB fundamentally changed compliance in three new and profound ways by: 1) enabling previously restrained market changes to occur and occur quickly; 2) giving a limited and indirect voice to consumer protection; and, 3) providing broad privacy initiatives.

GLB removed formal barriers between bank, brokerage and insurance companies creating a more unified financial services industry. In many ways this change was a bow to market pressure allowing large U.S. financial firms to compete on a world-

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wide basis, providing "one-stop" shopping for customers and enabling product and technology innovation to blossom. To the extent a bank expanded its scope of services outside of a traditional footprint (whether by engaging in a new industry or embracing new products or technology), it faced a wider array of compliance issues.

To temper the market, product and technology changes, GLB ushered in certain countervailing measures which can be categorized as either privacy or consumer protection concerns. GLB sought to protect minority lending by considering whether CRA examinations were "satisfactory" in merger approval or in the expansion of offered services. CRA changes were enacted giving the Department of Housing and Urban Development additional authority to regulate and enforce under the Fair Housing Act.[14] Regulators and consumer advocates were provided a tool to derail mergers or extract lending concessions during merger approval (all provided by the bank's own compliance reporting).

Privacy concerns were given a substantial voice as financial institutions were required to inform customers of the collection, dissemination, use and protection of account information, initially, annually and prior to any change. Beneath the model privacy notice, the "opt-out" provisions and pretexting concerns lay deeper compliance issues — formulating a written security plan, monitoring and testing security features, appointing a responsible privacy employee, training employees on privacy and security, and revising privacy and data security concerns as necessary. Amendments were made to many statutes, including the FCRA. A pattern emerged — unleash market possibilities, calm uncertainty with compliance regulation.

Compliance as a Crime Fighting Tool

The fourth horseman of the new compliance apocalypse, broad-based crime fighting, arose from the 2001 terrorist attacks. Within six weeks of September 11, the unwieldy "Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001",[15] more commonly known as the "USA PATRIOT Act" ("Patriot Act"), was passed. The Patriot Act substantially expanded a financial institution's duty to record and report transactions, particularly foreign transactions, encouraged communication with law enforcement, compelled greater knowledge of its customer, and expanded anti-money laundering laws. The Patriot Act also amended many other laws including BSA, MLCA, FCRA, and RFPA.

The Dam Breach

Concurrently with or shortly following GLB and the Patriot Act, a raft of new compliance statutes and regulations were passed including Electronic Signatures in Global and National Commerce Act of 2001 ("E-Sign"),[16] Fair and Accurate Credit Transactions Act of 2003 ("FACT Act"),[17] Check Clearing for the 21st Century Act of 2004 ("Check 21"),[18] and the "Red Flags" rules (effective for banks in 2008). Significant amendments to existing statutes and regulations were made on a continuing and frequent basis, particularly to TILA and HMDA (Regulation Z alone is nearly 300 pages). Each new or amended law or regulation increased the compliance burden. However, a clear trend emerged in the last year in favor of greater consumer protection. While banks were previously advised to "know your customer," banks' new compliance motto will be "protect your customer."

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'Legal' Compliance to Consumer Protection

The Credit Card Accountability Responsibility and Disclosure Act of 2009 ("CARD Act" effective dates in 2009 and 2010)[19] signaled a very clear pro-consumer message to the financial community. No longer would formal adherence to model notices, regimented forms and boiler-plate language suffice. Rather, the Administration and Congress would more fully dictate the terms, conditions, advertising and marketing of financial products, in this case, credit and gift cards. The CARD Act's purpose was to establish fair practices relating to open end consumer credit plans and gift cards. The regulations phased in on three dates in 2009 and 2010, with most regulations effective in February 2010. The government mandated enhanced disclosure of terms and conditions, enacted restrictions on fees, interest rate changes and interest calculation methods, formulated timing and payment application rules, banned certain "unfair" practices and increased penalties for violations.

Soon thereafter, the Federal Reserve Board ("Board") issued new rules, effective July 2010, for Regulation E amending EFTA.[20] The new regulations focused on account overdrafts caused by automated teller machine ("ATM") and one-time debit card ("OTDC") transactions. The Board, in setting forth the revisions, noted numerous potential operational challenges, including the processing of banking transactions on many different systems, differentiating between covered and non-covered transactions, and item timing issues. Notwithstanding these operational concerns, the Board believed the overdraft costs for small transactions were so great that before customers could be assessed overdraft fees, they needed an opportunity to "opt-in" in writing, having been provided with a segregated, written notice of the overdraft fees and charges associated with these transactions.

The culmination, to date, of consumer financial protection initiatives are four similar proposals; one from the Administration, one from the House and two from the Senate.[21] While there are key differences among the proposals, for instance whether the proposed consumer financial protection regulator ("proposed regulator") will be a separate agency or a bureau within the Federal Reserve Board, there are numerous common threads. First, consumer financial protection will have greater prominence, perhaps an "independent seat at the table in our financial regulatory system."[22] Second, the proposed regulator will have broad rulemaking, examination, enforcement and civil investigative powers.[23] Third, it will have authority over advertising, marketing, soliciting, sales, disclosures, delivery, maintenance and servicing of consumer financial products or services.[24] Specifically, the proposed regulator may review substantive provisions in which it has formed a "reasonable belief" that the act or practice will cause substantial injury to the consumer.[25] Fourth, each proposal limits federal preemption decisions in some way, potentially allowing **states** to develop, detect and deter fraudulent, unfair, deceptive and abusive acts or practices.[26] The shear expansion of the proposed regulator into so many core bank functions, potentially untethered to safety and soundness concerns, will cause innumerable headaches for compliance departments.

Major Issues Facing the Compliance Community

The breadth, depth and width of the regulatory changes have caused a variety of compliance challenges. Although there is a high level of interplay among major

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compliance concerns, these concerns can be grouped into five main categories: cost, uncertainty, pace, lost opportunities, and customer confusion.

Cost

Compliance costs have risen dramatically in the last few years. These increased costs spring from hiring new personnel (and related search costs), increased training for compliance specialists, expanded compliance training for employees at all levels, hiring consultants, and purchasing software to track, compile and report data. Reporting and examination burdens have increased substantially in the last decade and increased costs are inextricably linked to these factors. In a time of decreased net interest margins and restricted fee income on the revenue side, and rising non-compliance related expenses and charges, increased compliance costs (and related operational costs) will only exacerbate the drag on bank financial performance.

Uncertainty

Uncertainty concerns converge from several angles. Previously, compliance statutes and regulations were neatly ordered. Most new statutory changes affect several existing laws and regulations. Given the speed in which laws are passed and regulations drafted, clarity will suffer. Significant cross-referencing among many laws and regulations is routine and a certain amount of confusion will ensue. Additionally, the working relationship between regulator and bank has changed. Banks previously maintained strong working relationships with regulators (many have suggested too cozy a relationship), primarily because so many bank compliance employees were formerly employed by the government. Compliance officers could readily ask questions and receive sound answers from its regulator. This relationship tended to insure that many issues were addressed prior to implementation and, to the extent problems existed, same were caught and rectified at an earlier stage. Many experienced government examiners retired or otherwise left service. The federal government must hire significantly more employees above mere replacement numbers to keep up with all the growth and changes. A perceived deficiency in experience and training of regulators is an understandable concern. Regulators increasingly provide "advice" for the first time in examination results. The relationship between regulator and regulated is frequently adversarial and inconsistent.

Perhaps the greatest degree of uncertainty is caused by "what's next?" As stated above with regard to the consumer financial protection proposals, there are currently four proposals, of varying breadth — which, if any, will be enacted? Will states be allowed to enforce existing laws and develop new laws (most compliance personnel "don't do state law")? Will we have multiple, conflicting compliance exams performed by our "safety and soundness" and "consumer financial protection" regulators? Will federal regulators carry through on threats to more frequently find "unfair, deceptive and abusive acts and practices", a catchall phrase for "you were legally in compliance, but we do not like what you did."

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Pace

The sheer number of new laws and regulations creates a more frantic compliance pace. Focusing on a single new initiative, while maintaining on-going obligations, is no longer an option. New and amended laws take effect more quickly. While law enactment to regulation drafting (in consultation with the banking community) to implementation generally took a year in the old environment, it is now common for the process to take half that time (usually effective 60 days after rule adoption). The quickened pace often does not allow for sufficient time to draft and finalize rules, allow financial institutions to thoughtfully consider options or contact customers and engenders confusion in all constituencies. Recent examples include the frenetic pace of finalizing gift card rules, which amended Regulation Z pursuant to the CARD Act, and the initiative in November 2009 to move up many 2010 effective dates to December 2009.

Lost Opportunities

With so much effort expended in "keeping-up" with compliance and related operational issues, a perspective often lost is that new products are not developed or implemented. For instance, I have talked with many bank officers who tabled potential new products, such as issuing credit cards or expanding corporate debit cards, because of the need to stay focused on what the bank is presently doing and the uncertainty caused by the CARD Act. Internal focus crowds out the external quest for new customers, causes the drop or loss of existing customers and discourages innovation, new products and services. The CARD Act clearly stratified issuers' strategy as they seek more profitable customers and cancel or discourage less profitable customers (presumably those intended to benefit by the amendment) due to increased risk and lessened revenue from this segment. Similarly, many banks plan to drop any overdraft coverage for ATM/OTDC transactions because of the systemic burdens coupled with an insignificant revenue from these overdrafts. These foregone opportunities adversely impact both the banks and consumers.

Customer Confusion

Ironically, one of the clarion calls for compliance reform stems from customer confusion. The cause and effect of this confusion is reversed, however, as the increase in the size and complexity of deposit agreements, notices and loan forms, is a direct result of compliance initiatives. While a stated goal of the consumer financial protection initiatives is to aid consumers in making responsible decisions, there seems to be relatively little attention paid to providing relevant information. The CARD Act requires a statement of all overdraft fees and charges rather than just fees and charges related to ATM/OTDC transactions. Why this extraneous requirement if the goal is to provide information with regard to ATM/OTDC transactions? Many loan forms require information to track CRA, insider loans, loan concentrations, stress testing, know your customer and other information, which is, at best, largely irrelevant to the consumer. Pages of boilerplate notice intended to protect the consumer have had the opposite effect with documents going unread, misunderstood or tossed in the garbage. Relevance has been sacrificed to data compilation and information is a substitute for wisdom.

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The last decade witnessed an avalanche of compliance related burdens, dramatically altering the landscape. Today, standardized forms, notices and equal application of the law comprise a small portion of compliance duties. Increasingly law enforcement, privacy, market buffering and consumer protection concerns dominate compliance and permeate all areas of a financial institution. As a result, compliance is now a part (or should be) of nearly every bank decision, mundane to strategic.

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The views expressed herein are those of the author and do not represent those of Bloomberg Finance L.P.

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[1] Truth in Lending Act, 15 U.S.C. §1601 *et seq.* (1968); Regulation Z, 12 C.F.R. § 226
[2] Bank Secrecy Act, 12 U.S.C. § 1829 *et seq.* (1970)
[3] Fair Credit Reporting Act, 15 U.S.C. § 1681 *et seq.* (1970); Regulation V, 12 C.F.R. § 222
[4] Equal Credit Opportunity Act, 15 U.S.C. § 1691 *et seq.* (1974); Regulation B, 12 C.F.R. § 202
[5] Real Estate Settlement Procedures Act, 12 U.S.C. § 2601 *et seq.* (1974)
[6] Home Mortgage Disclosure Act, 12 U.S.C. § 2895 *et seq.* (1975); Regulation C, 12 C.F.R. § 203
[7] Community Reinvestment Act, 12 U.S.C. § 2901 *et seq.* (1977); Regulation BB, 12 C.F.R. § 228
[8] Right to Financial Privacy Act, 12 U.S.C. § 3401 *et seq.* (1978); Regulation E, 12 C.F.R. § 205
[9] Electronic Funds Transfer Act, 15 U.S.C. § 1693 *et seq.* (1978)
[10] Money Laundering Control Act, 18 U.S.C. §§ 1856–1857 (1986)
[11] Expedited Funds Availability Act, 12 U.S.C. § 4010 *et seq.* (1987); Regulation CC, 12 C.F.R. § 229
[12] Truth in Savings Act, 12 U.S.C. § 4301 *et seq.* (1991); Regulation DD, 12 C.F.R. § 230
[13] Financial Services Modernization Act, Pub. L. 106-102, 113 Stat. 1338 (1999)
[14] 12 C.F.R § 202.16(b)(5)
[15] USA Patriot Act, Pub. L. 107-56, 115 Stat. 272 (2001)
[16] Electronic Signatures in Global and National Commerce Act, 15 U.S.C. § 7001 *et seq.* (2000)
[17] Fair and Accurate Credit Transactions Act, Pub. L. 108–159, 117 Stat. 1959 (2003)
[18] Check Clearing for the 21st Century Act, 12 U.S.C. § 5001 *et seq.* (2003); Regulation CC, 12 C.F.R. § 229
[19] Credit Card Accountability Responsibility and Disclosure Act, Pub. L. 111–24, 123 Stat. 1734–1766 (2009)
[20] 12 C.F.R. § 205.17
[21] H.R. 3126, 111th Cong. (2009). The President and Senate Proposals have not received bill numbers. The President's Proposal was revealed on June 30, 2009, as the "Consumer Financial Protection Agency Act of 2009" ("CFPAA") and was preceded by the Department of Treasury's "Financial Regulatory Reform, a New Foundation: Rebuilding Financial Supervision and Regulation" white paper on June 17, 2009 ("Treasury Paper").
[22] Treasury Paper, p. 56.

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[23] Treasury Paper, pgs. 58–60
[24] CFPAA, § 1002(29).
[25] CFPAA, § 1031
[26] Treasury Paper, P. 61

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