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Regulation Innovation: Failures and Costs of Consumer Financial Protection Regulation

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FAILURES AND COSTS OF CONSUMER FINANCIAL PROTECTION REGULATION

Second in a series of six papers on Regulation Innovation

Note: This is the second in a series of papers arguing that traditional analog regulation intended to promote consumer financial protection and inclusion has largely failed and should be redesigned to leverage new digital technology that can make both finance and financial regulation better and less costly. For an overview of the series, click here. For the previous papers in the series, see here.

As discussed in Paper 1 in this series, the United States has sought for nearly a half-century to foster consumer financial fairness and inclusion through regulation, and the financial industry has responded with extensive investment in efforts to comply. It is timely to evaluate how well this strategy has performed, and at what cost, especially in light of the opportunity today to leverage digital technologies that offer the possibility of new and better strategies.

Effectiveness of Analog-Era Regulation

The legal and regulatory regime described in Paper 1 has accomplished important goals, including by outlawing and sharply curtailing credit discrimination on the basis of factors like race, ethnicity and gender. As discussed in Paper 1 in this series, such discrimination was both legal and widespread until, starting in the late 1960's, laws, regulations, and enforcement efforts forced most of it out of the system. While some discrimination persists, it is rare compared to the market conditions that preceded these regulatory efforts.

Nevertheless, taken as a whole, the current system does not deliver the results envisioned when these laws and regulations were conceived and launched.

In May 2016, Neal Gabler published a widely-noted article in *The Atlantic* citing a Federal Reserve Board survey in which 47% of respondents reported having no way to come up with $400 to cover a household emergency.[1] The article was entitled, "The Secret Shame of the American Middle Class."

[1] https://www.theatlantic.com/magazine/archive/2016/05/my-secret-shame/476415/

The sources of American financial insecurity are complex and include long term trends relating to wage levels, unemployment, structural shifts in labor markets and health care, and issues in education that impact people's income, wealth and opportunities – challenges that are beyond the scope of this paper. Overlaying these economic difficulties, however, is the additional fact that many people struggle with the financial system itself. Every adult, regardless of economic or social standing or demographic profile, has a financial life. Everyone – rich or poor, old or young -- takes in money and pays it out. Most try to save and want to be able to borrow. Excluding use of barter and some interpersonal transactions, nearly everyone employs formal financial services for most of these activities. The ability to access these services is foundational to people's quality of life – their ability to rent or buy a home, buy a car, pay for education, save enough to start a business, and retire securely, and, for many, to their ability to avoid debilitating stress arising from financial mistakes or exploitation. A growing body of research has found close connections between financial health and physical health, and between financial health and the social well-being of individuals and families.[2] [3]

The *Atlantic* article ties to a growing body of new research on the financial lives of Americans, much of which belies stereotypes that have shaped public policy for decades. Those stereotypes include the assumption that financial ill-health is a problem largely confined to lower-income demographics; that the problems of financially-unhealthy households are monolithic; and that problems result mainly from lack of income and/or behavioral failings. As discussed below, research is demonstrating that tens of millions of Americans are living within their means in the sense that they spend less than they make, but are nevertheless consigned to reliance on high-cost, non-mainstream services. A major driver of this phenomenon is rising volatility and unpredictability in their incomes and expenses. In other words, the problem for many consumers is not that they don't have enough money, but rather that they don't have it when they need it.

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[2] https://www.forbes.com/sites/brettwhysel/2018/06/27/3-vicious-cycles/
[3] https://www.marcus.com/us/en/resources/personal-finance/physical-and-financial-health

The primary options available to these people for smoothing out shortfalls, and to consumers who are struggling financially for other reasons, usually involve recourse to high-cost borrowing, such as payday lending, pawn shops, and checking account overdrafts, all of which can exacerbate the original problem by imposing high financing expense.[4]

Policy goals and metrics:

The new research should spark debate on whether current public policy aimed at consumer financial protection and inclusion is achieving its goals. Notably, however, this question of effectiveness and outcomes is largely absent from regulatory dialogue. While regulatory agencies and others do conduct research on household financial well-being, it rarely leads to reworking policy solutions, or even to discussion of how to assess their effectiveness. Sometimes Congress mandates that agencies study the effectiveness of a new statutes and regulations,[5] but these analyses rarely lead to significant regulatory adjustments.

In other highly-regulated realms, one can point to measurable results. For instance, despite occasional failures, America generally enjoys high levels of safety in food, drugs, drinking water quality, and airline travel. In consumer financial markets, in contrast, little effort is made to determine whether success is being achieved, or even to articulate what it looks like. Few financial laws and regulations describe desired end-states in terms that permit assessment of whether the policy has worked, quantitatively or even qualitatively. While this may be appropriate for rules that simply outlaw harmful

[4]One contributor to this trend has been curtailment of short-term loan offerings from financial institutions, leaving fewer options and less competitiveness on pricing and terms in this market. Another is the rise of checking account overdraft protection as a major product and revenue source for banks, leading some consumers to over-rely on this high-cost source of funds. Paper 3 in this series will look at the complex interplay of factors that produce undesirable outcomes for consumers.

[5]Studies do exist. For example, in January 2018 the CFPB released a study on the costs of mortgage rules mandated under the Dodd-Frank Law, finding the costs to be modest. https://www.americanbanker.com/news/cfpb-mortgage-rule-didnt-cost-industry-much-agency-says. In 2011, the newly-formed CFPB studied costs and effectiveness of the Credit Card Accountability, Responsibility and Disclosure Act, similarly finding good results https://www.consumerfinance.gov/about-us/newsroom/the-card-act-one-year-later/. The bank regulators also jointly review the costs and benefits of regulations periodically, a process that often yields suggestions for trying to reduce burden, especially on smaller banks. In addition, the Treasury Department in the Trump Administration has issued a series of papers on improving financial regulation. Most such efforts focus on ideas for reducing costs and burdens. The system lacks agreed-upon metrics for assessing whether regulatory efforts are producing the desired results.

practices, it falls short for policies intended to foster desired behaviors or market outcomes. In these areas, policymakers have generally operated on theory – an assumption that a given regulatory strategy will produce a beneficial outcome. For example, it is assumed that nudging banks to lend to lower-income consumers will produce widely affordable (and sound) credit access. It is assumed that providing financial education will result in high financial literacy, and therefore in sound consumer choices and behavior. It is assumed that mandatory, uniform financial product disclosures will engender good consumer decisions and therefore, indirectly, competitive markets and overall consumer financial health.

Instead of seeking to measure such outcomes, policymakers often use yardsticks that are detached from context. For instance, the Consumer Financial Protection Bureau (CFPB) reported that, as of July 2017, it returned $12 billion to 29 million consumers through enforcement activity.[6] Such a metric offers no insight as to whether this means that harmful practices are largely eliminated from the financial marketplace, or whether instead this work is the tip of an iceberg of ongoing consumer abuse.

Assessing consumer financial health:

Recognizing the metrics problem, the CFPB, in particular, has used its research mandate to strive for "empirically-based" policymaking. In that vein, the agency has qualitatively defined "consumer wellbeing," focusing on two attributes – financial security and freedom of choice – and mapping them against "present" and "future" perspectives, as follows in Figure 6.[7]

Similarly, the nonprofit Center for Financial Services Innovation,[8] or CFSI, has defined the related concept of "financial health," identifying three core elements: 1) smooth and effective management of day-to-day financial life; 2) resilience in the face of inevitable ups and downs; and 3) capacity to seize opportunities that will lead to financial security and mobility over time.[9]

[6] https://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-cfpb-director-richard-cordray-rainbowpush-coalitions-46th-annual-convention/
[7] http://files.consumerfinance.gov/f/201501_cfpb_report_financial-well-being.pdf
[8] Note: The author chairs CFSI's Board of Directors
[9] CFSI Financial Health Study Brief, 11/3/14
http://www.cfsinnovation.com/CMSPages/GetFile.aspx?guid=32a7d313-2718-4358-bb6c-55674ef00158
CFSI Financial Health Study Brief, 11/3/14 http://www.cfsinnovation.com/financial-health-segments#content

Figure 6

THE FOUR ELEMENTS OF FINANCIAL WELL-BEING (CFPB Report January 2015)

	Present	Future
Security	Control over your day-to-day, month-to-month finances	Capacity to absorb a financial shock
Freedom of choice	Financial freedom to make choices to enjoy life	On track to meet your financial goals

Source: Consumer Financial Protection Bureau

CFSI's research also divides "underserved" households into categories they call "striving," "tenuous," "unengaged," and "at risk." These are outlined in Figure 7.

Figure 7

CFSI – 4 types of households

	Striving	Tenuous	Unengaged	At Risk
Debt	42%	41%	86% do not know how much monthly debt payments	48%
Plan for unexpected shocks	100%	0%	38%	38%
Financial product use	40% use mobile financial services regularly	42% use mobile financial services	45% have a credit card	67% always/often use credit cards
Savings	50%	47%	62%	26%

CFSI: http://www.cfsinnovation.com/financial-health-segments#content

Source: Center for Financial Services Innovation

CFSI supplemented this study with another that produced a book called *The Financial Diaries.*[10] The project tracked 235 American families for more than a year, minutely recording all inflows and outflows of funds. The research found vast variation in the circumstances and activities of households that public policy generally lumps together by average income strata.[11] Households that look superficially similar may actually be financially rising or deteriorating. Some are overwhelmed by the complexity of money management and are relying on harmful and even predatory products. Others with similar income levels are among the best money managers in the population because, more so than more affluent people, they need to understand exactly how much money they will have, when, and exactly how much money they must pay to whom, at precisely what time.

This research also finds that tens of millions of consumers who are considered by the government to be "underbanked" are not poor, but rather are struggling with financial volatility and setbacks. Many have attributes commonly associated with financial success and middleclass lifestyles, owning homes and cars, holding jobs (often multiple jobs), and having successfully saved money in the past. In 2012, American Express sponsored research that produced a movie called *Spent: Looking for Change*[12] and supporting materials. They estimated that 70 million Americans were "underserved" by financial services, and that these consumers had spent $89 billion in fees and interest, up 8% from the prior year. The study also estimated that the average low-to-medium income unbanked person spends nearly $40,000 over his or her lifetime in unnecessary financial fees. One-quarter of all U.S. children live in underbanked households.

The FDIC's 2017 household survey[13] confirms this picture. As illustrated in Figure 8, its research found that more than one in five US households had limited banking services that year. Of these, 6.5% of

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[10] www.usfinancialdiaries.org/

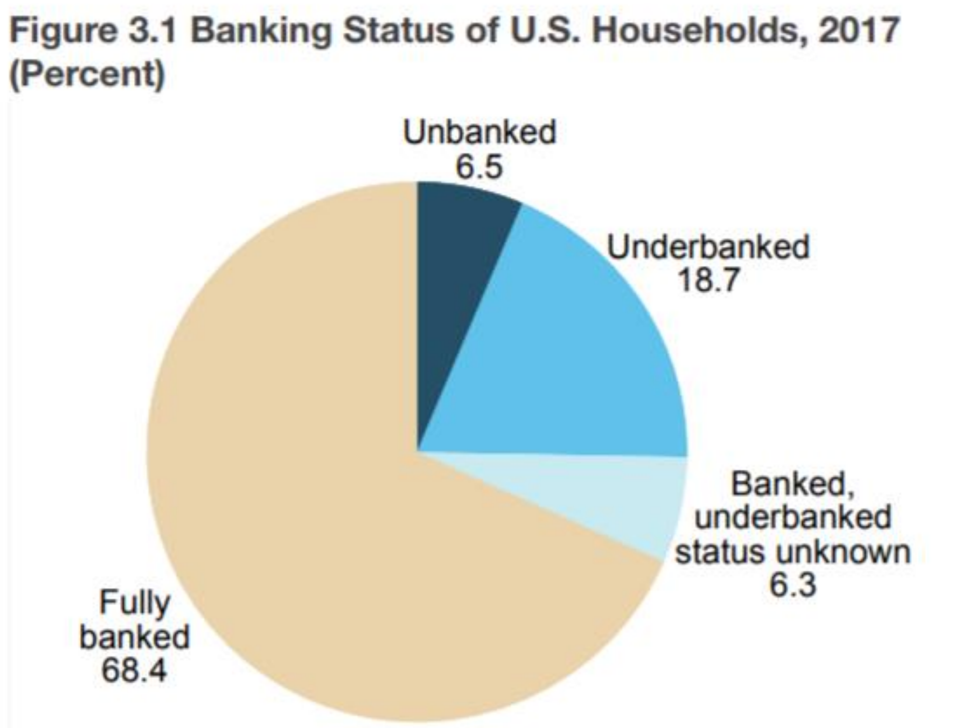
[11] Numerous policies contain tiers based on percentages of median income. For example, the Community Reinvestment Act regulations require banks to delineate a local "assessment area," and then measures lending and services offered based on whether census tracts within the area served are "low-income" or "moderate-income," based on percentage of median income for the metropolitan area.

[12] "Spent, Looking for Change," American Express 2014 http://www.spentmovie.com/

[13] https://www.fdic.gov/householdsurvey/2017/2017execsumm.pdf

U.S. households were unbanked, meaning they had no bank account, while an additional 18.7% were underbanked -- having a bank account but also using alternative financial services that are generally more costly.

Figure 8



Source: *2017 FDIC National Survey of Unbanked and Underbanked Households*

The FDIC survey also found that one-third of households with income above $50,000 were un- or underbanked in 2017, as shown in Figure 9. While the reasons for these limited bank connections vary widely, the numbers suggest that the public policy goal of "financial inclusion" is not being met.

Most underserved households have suffered a financial shock, such as a major medical crisis or loss of a job, which in turn caused loan defaults or bankruptcy that damaged their credit records. Others, again, have volatile sources of income that combine, say, a paycheck, seasonal or project-based work like construction, part-time work that has unpredictable hours, and work in the so-called "gig economy," like driving for a car service. Both scenarios make them higher risks, sometimes too high for banks to serve. The lenders that do serve them charge higher rates to cover the elevated risk.

Figure 9

Table 3.3 Underbanked and Fully Banked Rates by Selected Household Characteristics and Year
For all households

Characteristics	Underbanked			Fully banked			Banked, underbanked status unknown		
	2015 (Percent)	2017 (Percent)	Difference (2017–2015)	2015 (Percent)	2017 (Percent)	Difference (2017–2015)	2015 (Percent)	2017 (Percent)	Difference (2017–2015)
All	19.9	18.7	−1.2*	68.0	68.4	0.4	5.0	6.3	1.3*
Family income									
Less than $15,000	24.3	20.9	−3.4*	45.1	47.7	2.6*	4.9	5.7	0.7
$15,000 to $30,000	23.6	22.4	−1.2	59.5	58.3	−1.1	5.1	7.0	1.9*
$30,000 to $50,000	23.7	22.8	−0.9	66.2	65.4	−0.8	5.1	6.8	1.7*
$50,000 to $75,000	20.2	19.7	−0.5	73.0	72.8	−0.2	5.1	6.0	0.9*
At least $75,000	13.4	13.3	−0.1	81.3	79.9	−1.3*	4.9	6.2	1.3*

Source:2017 FDIC National Survey of Unbanked and Underbanked Households

However, many of the products these consumers use are structured in ways that are difficult to work out of, which means that these high costs can compound rapidly. For example, research by the Pew Charitable Trusts has chronicled the difficulty many consumers experience in paying off payday loans, and the resulting high incidence of rolling the credit over – a process that becomes very expensive over time.[14] Similarly, CFPB research finds that Americans pay $15 billion annually in bank overdraft fees; that 9 percent of overdraft users incur 79 percent of the fees; that these high users tend to have low or no credit scores; and that "frequent overdrafters" pay an extra $450 a year in fees.[15]

The American Express documentary captures the struggle of consumers in this position, who sometimes feel they have the equivalent of an additional job, simply to pay their bills each month – taking their paycheck to a check-casher (which is expensive), and then driving around town making payments in cash because an electronic payment might not arrive in time.

These consumers are able to pay for financial services, as evidenced by the fact that they do so – as a group, they pay higher rates and more fees than do other consumers. Nevertheless, they cannot access

[14] http://www.pewtrusts.org/en/research-and-analysis/collections/2014/12/payday-lending-in-america
[15] https://www.consumerfinance.gov/about-us/newsroom/cfpb-unveils-prototypes-know-you-owe-overdraft-disclosure-designed-make-costs-and-risks-easier-understand/

mainstream services because lower-cost providers cannot profitably manage the complexities of their situations. This leaves them vulnerable to expensive and suboptimal choices, and also to being preyed upon by abusive providers that exist in the financial industry, despite regulatory efforts.

These failures were dramatically manifested in the financial crisis that began in 2007, spurred by subprime mortgage lending. From 2006 to early 2015, approximately 6.7 million Americans lost their homes to foreclosure, and these numbers may have hit 800,000.[16] While some of these cases resulted from the wider recession triggered by the crisis, the subprime loans themselves produced very high levels of default and foreclosure. This market became infested with high levels of predatory practice and fraud. Still, there is little or no evidence that those mortgages generally failed to comply with federal disclosure mandates. Consumers accepted these loans, despite the disclosures, which suggests that the disclosures did not foster sound consumer decisions -- did not protect people who were taking on debt they could not afford.[17]

Failure of mandatory disclosures:

The fact that disclosures did not protect people in the financial crisis is one example of a systemic failure of the regulatory disclosure regime that was described in Paper 1. The reality is that most consumers simply do not read such disclosures and do not understand them even if they do.

In their 2014 book, *More Than You Wanted to Know: The Failure of Mandated Disclosure,*[18]

> *'Mandated Disclosure' may be the most common and least successful regulatory technique in American law*

Omri Ben-Shahar and Carl E. Schneider, of the University of Chicago and University of Michigan respectively, argue that "'Mandated Disclosure' may be the most common and least successful regulatory technique in American law," especially when complex decisions necessitate complex disclosures. The

[16] https://www.nytimes.com/2015/03/30/business/foreclosure-to-home-free-as-5-year-clock-expires.html
[17] The CFPB has issued new disclosure rules from mortgages as required by the Dodd-Frank Act, but the disclosure model, itself, has shown little ability to foster good decision-making.
[18] http://press.princeton.edu/titles/10267.html

authors cite a mismatch between complicated disclosures and the literacy and numeracy levels of most consumers, including "sectoral illiteracy" in areas like finance. Calling financial illiteracy "dangerously common," they quote the Federal Reserve as arguing that "people cannot use disclosures effectively without understanding markets, and products, but disclosures cannot practically provide that 'minimum understanding for transactions that are complex and that consumers engage in infrequently.'"

As discussed in Paper 1 in this series, disclosures have been the foundation stone of most financial consumer protection regulation, grounded in the logic that good information should be able to make markets serve consumers better by fostering better consumer choice. In *Disclosure: Psychology Changes Everything*, Cass Sunstein, George Loewenstein and George Golman describe this line of reasoning. "Mandatory disclosure of information, targeted transparency…is among the most ubiquitous and least controversial elements of public policy, often promoted as an attractive alternative to so-called hard forms of regulation…. An important advantage of disclosure requirements, as opposed to harder forms of regulation, is their flexibility and respect for the operation of free markets. Regulatory mandates are blunt swords; they tend to neglect heterogeneity and may have serious unintended adverse effects."[19]

As the authors note, this argument could be compelling if disclosures in fact worked, but the paper goes on to discuss the difficulty of making them effective, due to the psychology of both consumers and providers. "There are serious limitations on the amount of information to which people can attend at any point in time…Bounded attention renders many disclosures useless because consumers ignore them."

Even worse, behavioral economics research suggests that some disclosures can actually do more harm than good. The *Handbook of Behavioral Economics 2018's* chapter on Behavioral Household Finance cites multiple studies indicating a perverse effect when investment advisors disclose having a conflict of interest.[20] A 2005 laboratory experiment found that:

> *"….when conflicts of interest are disclosed, advisors give even more biased advice, perhaps because they feel they have the moral license to do so once advisees have been informed of their conflicts, or because advisors expect clients to discount their recommendations and so a more*

[19] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2312708

[20] *Handbook of Behavioral Economics*, Chapter 3 on Behavioral Household Finance by John Beshears, James J. Choi, David Laibson, and Brigitte Madrian, page 229.

extreme recommendation is needed to compensate. However, advisees in the experiment do not discount advice as much as they should when the conflict is disclosed, making them worse off as a result of the disclosure."

The same chapter cites a second study positing that "disclosure can actually increase the trust clients place in their advisors if the act of disclosure is interpreted as a sign of honesty. Furthermore, clients may feel more compelled to follow advice after a disclosure of financial conflicts has been made lest they be perceived as lacking trust, a phenomenon they refer to as the 'burden of disclosure.'"

A third study cited found that advisors may steer clients away from products that require more disclosure. A fourth notes that, "If consumers are facing information overload, disclosing commissions may limit the attention they give to other information relevant for a decision, diminishing decision quality."

Failure of financial literacy education:

The failure of disclosures intersects with a second flawed strategy that policymakers have used to promote consumer understanding and sound choices, namely financial literacy education. As discussed in Paper 1, financial education for consumers has been widely offered and promoted for decades. While research results are mixed, there is extensive evidence that conventional education produces poor results. A 2014 analysis of 168 research papers covering 201 prior studies found that "interventions to improve financial literacy explain only 0.1% of the variance in financial behaviors studied, with weaker effects in low-income samples. Like other education, financial education decays over time; even large interventions with many hours of instruction have negligible effects on behavior 20 months or more from the time of intervention."[21] Other research has found similar results, [22] including disproportionate illiteracy despite financial education among older Americans, especially those who are female, minority, and lower-income.[23]

[21] https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2333898
[22] https://www.financialeducatorscouncil.org/national-financial-literacy-test/
[23] http://www.nber.org/papers/w17078.pdf

The CFPB's statutory mandate includes promoting financial literacy and the agency, recognizing the research in the space, has made efforts to bring behavioral science into its work on both education and disclosures. The CFPB conducts consumer research when it issues new or changed disclosures. This has produced concerted efforts to streamline disclosures, but has shown little impact on the problem.[24]

Failure of anti-money laundering regulation:

As discussed in Paper 1, compliance with AML regulation is related to consumer protection efforts and consumes even more time and expense. Thus it is worth noting that these very extensive regulatory efforts have been strikingly unsuccessful. According to the United Nations Office on Drugs and Crime (UNODC), global money laundering reached approximately $800 billion to $2 trillion annually, or 2-5 percent of global GDP,[25] as long ago as 2009, and that less than 1 percent of this financial crime is caught. The international Financial Action Task Force, or FATF, offers similar numbers and suggests they may understate the volume of crime.[26] Yury Fedotov, Executive Director of UNODC, has said, "Tracking the flows of illicit funds generated by drug trafficking and organized crime and analyzing how they are laundered through the world's financial systems remain daunting tasks."[27]

One contributor to the ineffectiveness of AML regulation is over-reporting of suspicious activity, which is fostered by regulatory factors and which undermines the law's mission by inundating law enforcement in massive volumes of low-value information. The rules punish banks for failing to file a SAR in a case where they should have, but not for filing SARs that do not produce useful leads. This creates perverse incentives for banks to over-report in order to secure a regulatory safe harbor. The AML world speaks of a "rule of 10's," estimating that 90 percent of suspicious activity alerts from bank

[24] The CFPB's first head of research was Harvard University's Sendhil Mullainathan who, with Princeton's Eldar Shafir, wrote a landmark book entitled *Scarcity: Why Having Too Little Means So Much*. Their research detailed how behavior changes, and decisions become seemingly less rational, when people are deprived of resources like money, food, or time.[24] This analysis is an optimistic one in that it suggests that many harmful financial habits are not necessarily permanently tied to personality, but rather result from stress, so that removing the stressor may enable many people to make better choices. Providing them with disclosure forms and financial literacy classes cannot address this issue.

[25] https://www.unodc.org/unodc/en/money-laundering/globalization.html

[26] http://www.fatf-gafi.org/faq/moneylaundering/

[27] http://www.unodc.org/unodc/en/press/releases/2011/October/unodc-estimates-that-criminals-may-have-laundered-usdollar-1.6-trillion-in-2009.html

monitoring systems are false positives; that 90 percent of in-bank investigations do not merit filing a SAR; and that at least 90 percent of SARs are useless to law enforcement – and many law enforcement experts say that number should actually be much higher.

Furthermore, these law value reports are often worse than useless, because the excessive reporting makes it difficult for law enforcement agencies to find actual crime. In January 2018 I co-authored an article quoting former Department of Homeland Security Supervisory Special Agent Robert Whitaker as saying the glut of information can skew the whole system to focusing on the crimes that are easiest to find, instead of the ones that are most serious. It often enables the largest and most sophisticated criminals to "operate with little to no risk."[28] This suggests that the one percent of crime that is being caught may actually be low-priority, which would make those numbers even more alarming.

As discussed below in the section on costs, these abysmal results are absorbing very high levels of resources, as well as creating collateral damage by effectively blocking many people from access to the financial system. It's fair to say that there is widespread agreement in the financial, regulatory and law enforcement ecosystem that the current AML framework is highly ineffective, and that, in its current form, it cannot be scaled up enough to make a dent in these crimes.[29]

Costs of Today's Regulatory Approach

In summary, we have built a massive regulatory edifice that is producing poor results, and sometimes even counterproductive outcomes. It is appropriate to ask what it costs.

The costs of this system fall into two categories. The first is financial costs and waste. The second involves damage arising from unintended consequences. This section will look at each in turn.

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[28] https://www.americanbanker.com/opinion/regtech-could-help-stop-human-trafficking?brief=00000160-700b-dbf5-a562-788b36110000
[29] https://scholarship.law.nd.edu/cgi/viewcontent.cgi?article=1015&context=ndlr_online

Monetary costs and waste:

Compliance costs in finance are notoriously difficult to measure,[30] [31] [32] and it is even harder to break them down by type of regulation. Nevertheless, there is no dispute that they are high. As noted earlier, several studies estimate the overall cost of global financial regulation at roughly $100 billion per year and rising.[33] A 2017 European study by Duff & Phelps found financial executives predicting that compliance costs will more than double by 2020, rising from 4 percent to 10 percent of total *revenue*[34] (emphasis added). A 2016 Accenture study reported similar projections.[35] A study I coauthored as long ago as 1992 found a subset of regulations accounting for nearly 20 percent of bank operating expense, at a time when regulatory volume was a fraction of today's level.[36] The American Bankers Association has reported that 2013 costs for just the top six U.S. banks had doubled in one year, to $70 billion.[37] The *Financial Times* reported that annual compliance costs at some individual banks rose as much as $4 billion between the financial crisis and 2015, and that Citibank's compliance staff numbered 26,000 people.[38] At JPMorgan, compliance headcount grew to 43,000 people as of 2015, from 23,000 in 2011.[39]

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30 https://www.cnbc.com/id/100574254
31 https://www.marketplace.org/2016/04/13/world/its-surprisingly-hard-figure-out-what-big-banks-spend-follow-rules
32 https://faculty.chicagobooth.edu/john.cochrane/research/papers/cochrane_benefits_costs_JLS.pdf
33 https://letstalkpayments.com/a-report-on-global-regtech-a-100-billion-opportunity-market-overview-analysis-of-incumbents-and-startups/ and https://www.thetradenews.com/Sell-side/Banks-spent-close-to-$100-billion-on-compliance-last-year/
34 https://www.fnlondon.com/articles/compliance-costs-to-more-than-double-by-2022-survey-finds-20170427
35 https://newsroom.accenture.com/news/compliance-costs-for-financial-institutions-will-continue-to-increase-over-the-next-two-years-driven-by-regulations-and-emerging-risks-according-to-global-accenture-survey-of-executives.htm
36 The high costs for consumer protection compliance were cause for concern long before the additions created by the Dodd-Frank law. As long ago as 1992, I co-authored a study with Dr. Anjan V. Thakor, and Mr. Jess C. Beltz of Indiana University, examining costs of just three regulations. We found that "compliance with consumer protection regulations cost banks the equivalent of nearly 19% of net income in 1991" "…if costs of consumer regulatory compliance were eliminated and the savings were passed on to customers as lower interest rates on loans, rates would decrease by 11.5%, from 10.18% to 9.11%," with "ripple effects that would substantially increase credit availability in the economy." Common Ground: Increasing Consumer Benefits and Reducing Regulatory Costs in Banking, by Barefoot, Marrinan & Associates, Inc.; Dr. Anjan V. Thakor, and Mr. Jess C. Beltz, Indiana University, 1992.
37 https://blogs.wsj.com/moneybeat/2014/07/30/the-cost-of-new-banking-regulation-70-2-billion/?mg=prod/accounts-wsj
38 https://www.ft.com/content/e1323e18-0478-11e5-95ad-00144feabdc0
39 http://www.pymnts.com/news/security-and-risk/2016/banks-spend-and-hire-in-new-regulatory-environment/

In 2015, Trulio summed up the cost trend as follows. "In 2013, JPMorgan added 4,000 employees to their compliance team and spent an additional $1 billion on controls. Citigroup reported that of the $3.4 billion in costs that they had saved in the past year through greater efficiency, 59 percent of that was then being consumed by new compliance spending. UBS spent nearly $1 billion in 2014 in order to meet regulatory requirements. HSBC grew their compliance department from 2,000 to 5,000 in 2013, and it currently stands at over 7,000."[40]

In 2016 Bain & Co. stated, "We estimate that governance, risk and compliance (GRC) costs account for 15% to 20% of the total "run the bank" cost base of most major banks."[41]

Compliance operating costs are hard to measure because they have become absorbed over time into almost everything a financial company does, in addition to the direct costs of financing the compliance unit. Compliance expense threads through IT systems, legal work, nearly all activities involving documents, transaction processing, employee training, employee job descriptions and recruiting, employee performance evaluation and compensation plans, quality control, signage, advertising, marketing, complaint handling, vetting and managing of vendors and third-party relationships, evaluating and executing mergers and acquisitions, locating of facilities, and nearly everything else. It ranges from whether each teller window is displaying an FDIC sticker and each mortgage advertisement contains an Equal Housing Lender logo to conducting sophisticated statistical validation of underwriting models and running regression analyses to assure that "similarly situated" borrowers have been similarly treated. For most banks, expenses include substantial fees paid to outside legal and consulting experts[42] and expenses for vendors – again, essentially everything. Outlays are high in the U.S. (and globally).[43]

[40] https://www.trulioo.com/blog/are-compliance-costs-hurting-banks-bottom-lines/

[42] https://www.ft.com/content/78f0a48e-b886-11e6-961e-a1acd97f622d

[43] https://www.gfmag.com/magazine/may-2015/unavoidable-costs-increasing-regulation-compliance-goes-global

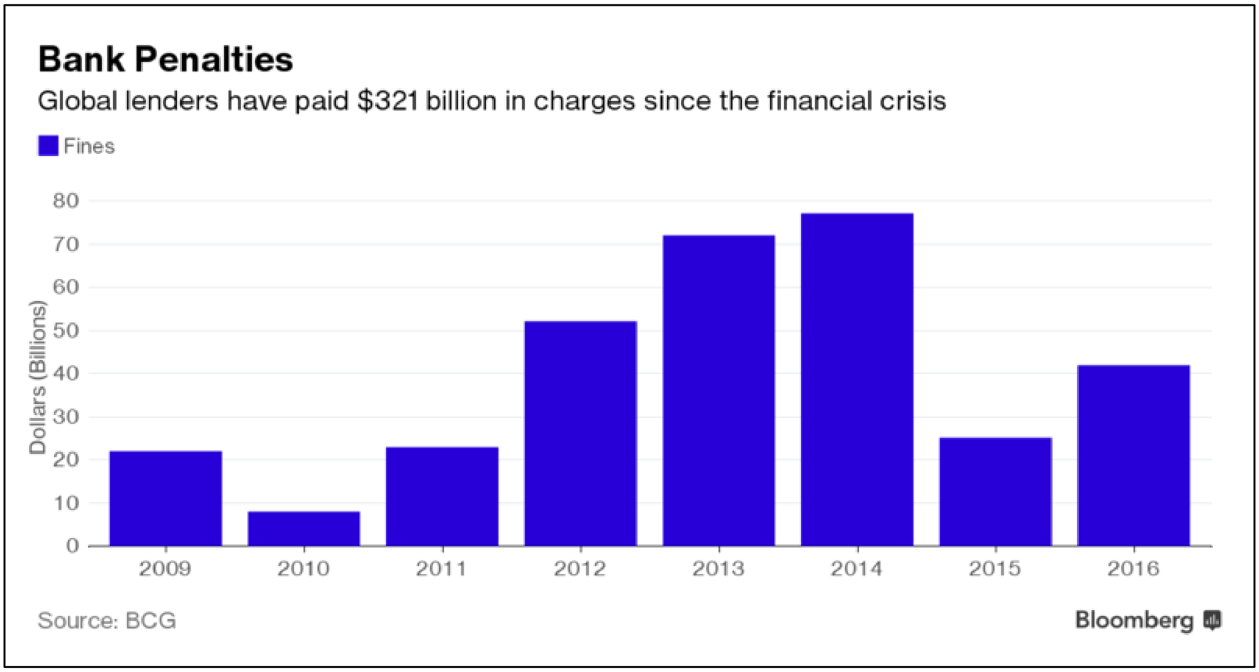
In addition to operating costs, regulatory fines for noncompliance have skyrocketed. *Bloomberg* estimates that lenders paid $321 billion in penalties from 2009 to 2016 (see Figure 11).[44] Figure 10 presents penalties imposed by US regulators as of 2017, as reported by the *Financial Times*. An analysis by Keefe Bruyette and Woods indicates that banks were fined $243 billion between the financial crisis and February of 2018.[45]

Figure 10

Source: Financial Times[46]

[44] It should be noted that penalty payments are tax deductible. Also some have been widely perceived as a "cost of doing business" for some players in the industry and therefore have been factored into product pricing to cover the projected expense. This has often prompted regulators to impose stiffer assessments, to enhance the deterrent effect.
[45] https://www.marketwatch.com/story/banks-have-been-fined-a-staggering-243-billion-since-the-financial-crisis-2018-02-20
[46] https://www.ft.com/content/71cee844-7863-11e7-a3e8-60495fe6ca71

Figure 11



Source: Bloomberg

While penalties have abated from post-crisis peaks, they remain very high. Anti-money laundering fines tend to be among the highest. In 2012 HSBC was fined $1.9 billion for AML problems.[47] In 2017, Deutsche Bank was fined $700 million for AML failures (and a year later announced plans to hire 400 additional compliance people, despite embarking on a 4,000 person cut in net headcount company-wide).[48] In 2014, BNP Paribas settled a case with the U.S. Department of Justice agreeing to pay $8.9 billion in penalties for illegally processing transactions.[49]

In non-AML penalties, Wells Fargo in 2018 agreed to pay $2.9 billion in civil fines regarding mortgage securities practices, as well as $1 billion earlier in the year over sales practices on automobile

[47] https://www.reuters.com/article/us-hsbc-probe/hsbc-to-pay-1-9-billion-u-s-fine-in-money-laundering-case-idUSBRE8BA05M20121211
[48] https://www.bloomberg.com/news/articles/2018-08-03/deutsche-bank-says-money-laundering-controls-still-too-complex
[49] https://www.justice.gov/opa/pr/bnp-paribas-agrees-plead-guilty-and-pay-89-billion-illegally-processing-financial

and mortgage lending.[50] This was on top of previous widely-reported fines relating to unauthorized opening of accounts.[51]

Penalty-related costs differ in nature from compliance management costs, since companies that fail to follow the law have essentially brought these outlays down upon themselves. Nevertheless, the two expense categories are related in that many enforcement situations do not involve willful illegality. In most cases, banks experience compliance failures despite investing heavily in avoiding them.[52] This reflects the fact that compliance under today's regulatory model is intrinsically difficult to achieve (for the reasons discussed in Paper 1 of this series), and that its high costs lead to constant risk of falling short. Headline-making enforcement cases are widely understood to be meant, among other things, as enforcement agencies "sending a message" to the industry, warning that compliance cost containment is dangerous. (Paper 4 in this series will discuss the potential for changing this dynamic through regtech that can simultaneously reduce costs and compliance failures).

To give texture to expense statistics, it is instructive to examine a routine example of costly compliance activity. Figure 12 presents a question posed on the website of Bankers Online in 2015. [53]

An erudite reply to this inquiry was posted by Bankers Online's John Burnett. His answer consisted of three paragraphs that included five regulatory citations from two federal agencies and was ultimately somewhat inconclusive. Mr. Burnett signed himself, "Professional Compliance Nerd since 1976."

Note that in this real-life scenario, the question was coming from someone who had doubts about information he had received from his own bank's compliance department, which evidently had already spent time researching the matter but which had come up, according to Bankers Online's expert, with the

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[50] https://www.reuters.com/article/us-wells-fargo-penalty/wells-fargo-to-pay-2-09-billion-fine-over-decade-old-mortgage-loans-idUSKBN1KM5TR
[51] https://www.forbes.com/sites/maggiemcgrath/2016/09/08/wells-fargo-fined-185-million-for-opening-accounts-without-customers-knowledge/#5a22281a51fc
[52] Broadly speaking, this observation may be less true in anti-money laundering, where enforcement cases often cite companies for willfully or negligently ignoring problems they should have addressed, and in some cases, for actually colluding in the crime.
[53] Https://www.bankersonline.com/forum/ubbthreads.php/topics/2032267/Size_of_Equal_Housing_Lender_L.html

wrong answer. The exchange illustrates where a large share of compliance expense goes, as struggles like these occur daily in every financial company.

Figure 12

> *"Our Compliance Department has given us updated guidance for print ads promoting mortgage products that appear to be lifted from HUD's "Part 109 Fair Housing Advertising" document. The document states that if the size of the ad is 1/2 page or larger, the EHL logo should be 2"x2" which is HUGE! In the past, we've only been asked to make sure the text is legible and it's similar in size to the FDIC logo used. The same guidelines state for a 1/8 page up to 1/2 page ad, that a 1" x 1" logo is used - also very large for that size of ad.*
>
> *"These guidelines from HUD, however, seem to only be addressing the advertisement of a dwelling for sale, and reference only the EHO logo. Does this really apply to advertising of loan products? If it does, I don't think I've ever seen it done correctly. Unfortunately, I don't find any alternative anywhere to use in challenging them on this. Thanks!"*

Source: Bankers Online

This example also raises the issue of waste. For some compliance activities, it's worth pondering the value of the effort that must be invested. While no regulations are more important than those barring discrimination, how much good is done today by customers seeing an Equal Housing Lender logo of any size, in an ad (See Figure 13)? The Fair Housing Act became law in 1968 – a half century ago. Prior to that, credit discrimination was legal. As a result, policymakers took the logical step of implementing the new law with a requirement that every mortgage lender must issue a clear public communication that it would henceforth treat all customers without bias. Today, however, how many customers doubt that lenders are supposed to avoid discrimination? If borrowers do worry about discrimination, how many believe that seeing an equal housing lender logo will provide protection and make them feel encouraged to apply for loans and expect fair treatment? And how much will such a consumer be influenced by whether the lender has properly put a ruler to the ad and assured that the logo is large enough to satisfy technical requirements?

Figure 13

Examples of Federally-Mandated Notices That Must Appear in Specified Communications and Signage

A former examiner told me of an episode where his regulatory agency criticized a bank for not affixing the *Member FDIC* logo (see Figure 13) to candy bags it handed out for Halloween. I once saw a bank criticized because the FDIC sticker was not on a waste basket. Such cases are of course rare, but reflect, again, a hyper-technical approach intrinsic to much of consumer financial protection regulation.

As discussed earlier, anti-money laundering compliance costs are even higher than the regulatory costs for consumer protection and financial inclusion. In October 2018, LexisNexis Risk Solutions released a survey of 150 executives estimating that US financial services firms spend $25.3 billion per year on anti-money laundering compliance.[54] A 2016 study found U.S. banks spending $8 billion annually on AML related "processes" alone.[55]

A 2015 article in *Notre Dame Law Review Online* entitled "The Failure of Anti-Money Laundering Regulation: Where is the Cost-Benefit Analysis?" contains a section subheading called, "Compliance Costs are Sky-Rocketing." It reports that, "HSBC recently estimated it now devotes $750 million to $800 million per year on compliance—an amount equivalent to one quarter of the operating budget of its entire U.S. operations—to fight against financial crime." The article indicates that from 2012

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[54] https://www.marketwatch.com/press-release/anti-money-laundering-compliance-costs-us-financial-services-firms-253-billion-per-year-according-to-lexisnexis-risk-solutions-2018-10-10

[55] https://www.globalradar.com/aml-compliance-costs-how-much-is-enough/

to 2015, HSBC had expanded its compliance staff by about 5,000 people, at a cost of approximately $300 million in salary.

The same article's authors, Lanier Saperstein, Geoffrey Sant and Michelle Ng, stated, "To a large

To a large extent, the fight against financial crimes has swallowed up the core business of banking, such as providing loans and banking services.

extent, the fight against financial crimes has swallowed up the core business of banking, such as providing loans and banking services. Regulators appear to have shifted their focus to how much banks spend on compliance, as opposed to the effectiveness of compliance efforts. The Office of the Comptroller of the Currency recently described it as a 'hopeful sign' and 'impressive' that many of the 'largest banks are increasing spending by significant amounts and adding substantial numbers of employees' in anti–money laundering compliance, a 'trend we want to encourage.'"

Again, these AML cost numbers need to be juxtaposed with the very low success rates discussed in the last section, including the UN estimates that current systems catch only about one percent of the crime.[56] While the law's goals enjoy universal support, the rules and technology used by both government and industry are still rooted in analog data and processes that results in the worst of both worlds, being both highly expensive and highly ineffective.

Compliance costs of all kinds are disproportionately high for smaller banks, a fact that tends to drive some of them to curtail many kinds of consumer services. A survey of 974 community banks by the St. Louis Federal Reserve bank found this pattern. Compliance expense at the surveyed small banks amounted to $4.5 billion in 2014, or 22% of net income. This broke down as 11 percent of these banks' personnel expenses; 16 percent of data processing expenses; 20 percent of legal expenses; 38 percent of accounting and auditing expenses; and 48 percent of consulting expenses.[57]

[56] http://www.unodc.org/unodc/en/press/releases/2011/October/unodc-estimates-that-criminals-may-have-laundered-usdollar-1.6-trillion-in-2009.html
[57] https://www.stlouisfed.org/on-the-economy/2015/december/compliance-costs-community-banks-billions

These levels are high enough to raise concerns about the economic viability of some smaller banks.

Unintended consequences and regulatory backfire:

The monetary costs of these regulations are compounded, in some areas, by additional indirect costs in the form of policies that sometimes undermine the very goals they are intended to achieve, or that impede the public the policy objectives of other regulations.

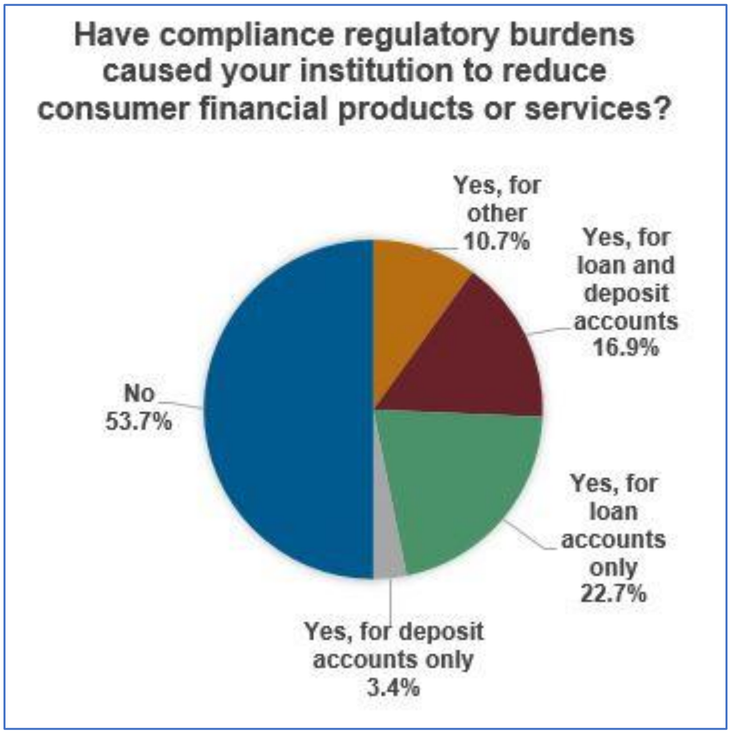
One such unintended outcome is that the costs and risks of regulatory activities can accidentally constrict customer access to services. The American Bankers Association conducted a survey of bank compliance officers in 2015 (see Figure 14), and found that regulatory concerns caused 46.3 percent of responding institutions to curtail loans, deposits or other services and 46 percent to decide against expanding products, channels or markets. Another 33.8 percent had declined mortgage loans to otherwise qualified applicants due to the CFPB's mortgage rules on ability-to-pay, with about one-third of banks (especially those under $10 billion in assets) ceasing all mortgage lending that did not meet the new regulatory definition of Qualified Mortgage Loans.[58] Among other things, those rules made it harder to make loans to older customers who might have sufficient wealth to service a mortgage, but lack active income streams. The same ABA survey found that smaller banks had been forced to curtail customer service in order to fund increased headcount and budget for compliance.

A similar unintended constriction of financial access arises from the AML Know-Your-Customer mandates. These aim to keep financial crime out of the banking system but have resulted in blocking financial services for many innocent consumers and small businesses who lack traditional identity records or whose identity verification or risk profile is complex. Current systems make it expensive and difficult for financial companies to finetune this risk screening, with the result that groups that present above-average money laundering risk profiles are often cut off *en mass*. This "de-risking" has impacted whole

[58] http://www.aba.com/Press/Pages/073015BankComplianceOfficerSurvey.asp

industries and sectors and, in the developing world, whole countries,[59] because de-risking tools that cannot efficiently sort out good customers from bad ones.

Figure 14



Source: American Bankers Association

In the United States, banks and financial companies err on the side of blocking customers who display attributes sometimes associated with heightened risk, because it is too expensive to fully assess their situations and because the bank cannot afford to make mistakes that tilt in the other direction. AML has been called "the new redlining."

The Association of Certified Anti-Money Laundering Specialists, known as ACAMS, has said, "…de-risking has left many legitimate businesses and economies with limited or no access to the global financial system, and in some cases has led to humanitarian crises."[60] [61] A 2015 report by Oxfam and the

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[59] https://www.acamstoday.org/de-risking-does-one-bad-apple-spoil-the-bunch/
[60] https://www.acams.org/aml-resources/de-risking/
[61] https://www.acamstoday.org/de-risking-and-financial-inclusion/

Global Center Cooperative Security said, “There is an observed trend toward de-risking of money service businesses, foreign embassies, nonprofit organizations, and correspondent banks, which has resulted in account closures in the US, the UK, and Australia…which can further isolate communities from the global financial system and undermine AML/CFT[62] objectives.” [63]

Wholesale exclusions are widespread enough to prompt regulators to warn against them, [64] [65] but the industry still faces much more regulatory exposure from accepting risky individuals or businesses as customers than from turning them away or terminating their accounts.

Interviewed for this paper, AML expert Matthew Van Buskirk[66] describes the challenge facing KYC compliance personnel at a bank or fintech. “It parallels the problems with underwriting loans for people with thin or no credit files. For KYC, if the company had unlimited time, it could sort these situations out. In reality, though, time is limited.” He says new customers are typically checked against an electronic screening system. If their identity comes back as “unverifiable,” the company may move to a second level of automated screening and/or undertake a step of manual screening, such as by requesting that the customer take a selfie photograph capturing his or her face and identification document together. If such efforts fail, however, the company will decline to open the account. Examples of affected customers could include people living in group housing who do not personally pay utility bills, or who have moved frequently because they cannot find permanent housing, or who use a prepaid phone rather than having their own mobile, since prepaid phones are a red flag. As with credit, many people in this category are actually good risks -- they just cannot easily prove it electronically. They are often the very consumers for whom policymakers want to encourage greater, not less, access to financial services. Innovative solutions to these problems are discussed in Paper 3, on fintech, and Paper 4, on regtech.

[62] CFT is an abbreviation for Combatting the Financing of Terrorism
[63] https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/rr-bank-de-risking-181115-en_0.pdf
[64] https://www.occ.treas.gov/news-issuances/speeches/2016/pub-speech-2016-117.pdf
[65] https://www.fca.org.uk/firms/money-laundering/derisking-managing-risk
[66] Former bank examiner and now CEO of Hummingbird Regtech (note that the author is a cofounder of the firm)

KYC rules can also impede desirable innovation in consumer finance. A 2017 Harvard paper by leading behavioral economists argues for increasing savings levels by permitting automatic enrollment in employer-sponsored savings funds for emergency "rainy day" uses, as well as for retirement.[67] One attractive option identified would be to allow these accounts to be opened as bank savings accounts, rather than in 401(k) or other retirement vehicles. The authors say, "A further complication is the Know-Your-Customer rules designed to prevent bank accounts from being used for criminal or terrorist activities. In general, these rules require banks and credit unions to establish the identity of the account owner prior to opening the account (with certain exceptions for employer-sponsored ERISA plans). This would seem to rule out automatic enrollment into a rainy day account outside of a plan, although there is a potential way to avoid this complication if the bank or credit union permits deposits to come only through the employer…" The paper goes on to discuss whether the latter strategy could solve the KYC problem and also state laws barring employer garnishment of wages. The example illustrates the challenges facing financial innovators as existing regulations potentially prevent development of new, pro-consumer ideas as technology creates regulatory gray areas where it is not clear whether and how change could be made, without incurring legal and regulatory risk.

Again, Paper 4 in this series will discuss new regtech technologies that have huge potential to solve all of these AML problems.

In the U.S., arguably the most damaging example of regulatory backfire relates to enforcement of the fair lending laws against credit discrimination. Pursuant to a U.S. Supreme Court ruling in 2015,[68] regulators can use "disparate impact" legal doctrine to conclude, based on statistical analysis of lending outcomes, that creditors have engaged – even inadvertently – in unlawful discrimination. As discussed further in Paper 3, the legal and statistical standards for making this kind of determination are unclear. This creates sharply heightened regulatory risks for lenders that attempt to serve lower-income market

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[67] John Beshears, James J. Choi, J. Mark Iwry, David C. John, David Laibson, and Brigitte C. Madrian, Pages 28 and 41-42. https://scholar.harvard.edu/files/laibson/files/2017-10-25_rainy_day_paper_final_2.pdf
[68] https://www.natlawreview.com/article/us-supreme-court-upholds-disparate-impact-claims-fair-housing-act-cases

segments, because these markets receive especially close regulatory scrutiny for potential discriminatory outcomes, and the scrutiny involves subjective standards that the lender cannot confidently forecast and implement. Virtually all loan product terms and underwriting standards produce some kind of disparate impact on one group or another correlating with factors like race, ethnicity, national origin, religion, sex and others that, under the law, cannot be used in making lending decisions. In part, this reflects the fact that in our society, these factors often align with attributes that impact creditworthiness, such as income, wealth, and job stability. Ironically, public policy seeks to encourage lending to minorities, but makes it dangerous for lenders to meet their credit needs, due to heightened and unclear regulatory risk. The result is a lessened flow of credit to the very customers for whom policymakers want to expand access.

Similarly, banks have affirmative obligations under the Community Reinvestment Act that can cause them to hesitate to open branches near lower-income areas, out of fear that regulators will then require them to expand more deeply into markets that could be less profitable for them, or that regulators would block them from closing such a branch if it does not perform well. As with the fair lending disparate impact issue described above, edging toward serving markets that draw heightened regulatory scrutiny – scrutiny exercised through subjective, uncertain standards -- is high-risk. Many banks thus avoid doing so, producing, again, the opposite of the desired regulatory results.

Another unintended effect of regulatory uncertainty and burden is that they can deter new competitors from entering financial fields, especially banking. This can reduce competition and innovation.

A final factor is that high regulatory costs, in and of themselves, make financial services structurally more expensive to produce, and thus less affordable for many consumers. Every financial service carries a kind of "regulatory tax" that adds to its price tag.

The high costs of compliance should be evaluated in relation to the unsatisfactory and sometimes perverse outcomes described above. This in turn raises the question, what would it cost to achieve good outcomes? In the anti-money laundering example cited earlier, moving from a success rate of 1 percent to 99 percent in catching financial crime, assuming continuance of current techniques, would absorb roughly the GDP of the United Kingdom, every year. Current compliance systems cannot be scaled up enough to accomplish the public policy goals that led to their creation.

Future Papers in the Series

It may be argued that, despite this record of poor outcomes attained at substantial cost and sometimes with backfire effects, current consumer regulatory policy is nonetheless justified if it is the best that can be done. That contention may in fact have been valid in the past. Today, however, better consumer solutions are available due to technology change, which is both refashioning financial services themselves and also opening opportunities to make regulation simultaneously more effective and efficient.

The next two papers in the series will explore these opportunities. Paper 3 will examine how innovative "fintech" can solve numerous consumer financial problems in areas where regulation has largely failed. Paper 4 will explore how digitized "regtech" can transform the regulatory process itself, simultaneously improving results and reducing the costs of compliance for government, industry, and ultimately to consumers.

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