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"Fairness and Effective Compliance Risk Management"

Remarks at Consumer Bankers Association (CBA) LIVE

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Thank you for the opportunity to participate in this year's CBA LIVE event. It is a pleasure to be here.

I want to applaud this year's conference theme: "For the People." The banking system exists to support people and their communities. This sometimes gets lost in debates about the economic outlook, regulatory agenda, or business opportunities. This year's conference theme reminds us that what matters most in banking is people, not products, services, institutions, or technologies.

In line with this theme, my remarks today are going to focus on compliance and fairness. More specifically, I believe that banks can improve the effectiveness of their compliance risk management programs by developing a strong internal sense of fairness.

As we all know, complying fully with applicable laws and regulations can be challenging for a bank to achieve and to sustain. These challenges can compound during times of change and uncertainty—for instance, when technology, innovation, and competition lead to new products, practices, and modes of analysis or when societal perceptions and norms evolve.

Banks' deployment of more and better resources can improve the effectiveness of their compliance risk management programs, as can their adoption of modern technologies. In many cases both are necessary. But they may not be sufficient.

In environments of change, executing well-designed and resourced compliance programs is just half the challenge. The other half is adapting and *anticipating* where compliance risks are likely to emerge. To do that, having a strong sense of fairness can be important.

The Rising Profile of Consumer Compliance

Admittedly, this idea is not new. In 2016, then-Comptroller of the Currency Thomas Curry made an explicit link between safety and soundness, fairness, and compliance. He said, "The overall health of a bank results from the quality of its management, how it tackles operational risk, and its commitment to compliance and treating customers fairly and incenting employees to do the right thing each day."[1]

This statement echoed sentiments expressed by then-Federal Reserve Board Governor Daniel Tarullo in a speech titled, "Good Compliance, Not Mere Compliance."[2] In it, he focused on the role of bank culture on compliance and compliance breakdowns, such as those related to LIBOR manipulation and facilitation of tax evasion. Tarullo defined "mere compliance" as a check-the-box attitude in which "compliance with applicable law or regulations is understood to be just that, *and that alone*" (emphasis added).

I am reiterating and building off these points because of their growing salience today. Changes in product offerings and the competitive environment are occurring at an increasingly rapid pace. This presents an evolving range of potential benefits and risks to consumers—and a challenging landscape for compliance risk managers.

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[1] Thomas J. Curry, Comptroller of the Currency, "Remarks Before The Clearing House Annual Conference," November 30, 2016.

[2] Daniel K Tarullo, Board of Governors of the Federal Reserve System, "Good compliance, not mere compliance," October 20, 2014.

Consider, for instance, the pace of innovation and growth in consumer financial products. The share of credit cards used as the form of payments has increased over 50 percent since 2016.[3] Buy now pay later (BNPL) has grown exponentially since its introduction a few years ago.[4] And earned wage access (EWA) usage tripled from 2018 to 2020,[5] with a 2023 survey indicating that 34% of employees already receive or want access to their wages as they earn them.[6] This growth in products is correlated with and has been driven, in part, by more and more Americans identifying themselves as living paycheck to paycheck.[7]

At the same time, the digitalization of banking has coincided with an expansion of third-party arrangements, a sharp increase in fraud, and heightened concerns with cyber risk and illicit finance. While digitalization has been net positive for both consumers and banks, it has significantly increased the operational and compliance complexities of banking.

Finally, the past few years of pandemic life and social reckoning in our country has focused greater attention on inequality, the wealth gap, and barriers to financial inclusion. Whereas before these may have been seen as nice-to-haves and the province of corporate philanthropy departments, today there is broad recognition by bank leaders that persistent

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[3] Federal Reserve Bank of San Francisco, "May 2022 Findings from the Diary of Consumer Payment Choice," May 5, 2022.

[4] Kate Fitzgerald, "Buy now pay later lenders face holiday risk tests," American Banker, December 11, 2023.

[5] Lux, Marshall, and Cherie Chung, "Earned Wage Access: An Innovation in Financial Inclusion?" M-RCBG Associate Working Paper Series 2023.214, Harvard University, June 2023.

[6] American Payroll Association, "2023 'Getting Paid in America Survey' Results."

[7] Emily Batdorf, "Majority of Americans Live Paycheck To Paycheck: Statistics 2024," Forbes Advisor, February 15, 2024.

inequality breeds mistrust and that supporting financial inclusion is table stakes for those engaged in consumer banking.

In short, successfully balancing innovation and growth with safety, soundness, and fairness is getting harder. Consumer banking and compliance are more inextricably linked now than ever. This presents a challenge—and an *opportunity*—for banks and how they approach compliance risk management.

Fairness as a guide and input to effective compliance risk management

The traditional zero-sum game approach is to trade off compliance with innovation and growth, meaning more of one means less of the other and vice versa. This is shortsighted. Strong and effective compliance risk management should lead to greater freedom and more certainty to innovate and grow.

A well-developed sense of fairness can help ensure that compliance risk management practices are effective, especially in areas that are evolving.

Take, for instance, overdrafts. In the early 1990s, banks permitted customers to overdraft an account and charged a fee for that privilege. Banks expected it to be used infrequently. What began as an accommodation steadily grew into a profit center for some. In 2015, when banks started reporting a breakout of their fees, consumer overdraft related fees totaled roughly $11.2 billion.[8] The slow and steady growth of overdrafts impacted customers and masked concerning practices. Beginning in late 2021, the OCC, CFPB, and other agencies began advocating for

[8] Call report data is available on the FFIEC Central Data Repository's Public Data Distribution site. Call report data excludes overdraft-related service charges generated by banks with assets of $1 billion or less as of the reporting quarter, which are not required to report overdraft-related service charges as a separate line item in their call report data. It also excludes overdraft-related service charges generated by all credit unions.

reform,[9] issuing risk-management guidance,[10] taking enforcement actions,[11] and initiating a rulemaking[12] to clarify the guardrails for overdrafts. Since then, consumer overdraft related fee revenues generally have declined, to $6.0 billion in 2023, and overdraft program features have become more pro-consumer.[13] More importantly, banks that had adopted or pivoted early to a fairness approach to overdrafts—i.e., limiting fees and empowering consumers—have been able to go on offense and strengthen their retail deposit franchises.

The historical experience of overdrafts carries lessons for banks, especially considering the growth of BNPL, EWA, and so-called "tip-based" models, where consumers pay "tips" instead of explicit fees or interest. What may seem manageable at first from a compliance risk perspective, can become much more complicated over time.

A well-developed internal sense of fairness can help a bank navigate these waters. For instance, most would agree that a financial product that is predatory and entices vulnerable populations into high-cost debt traps for non-essential purchases is not consistent with the notion of fairness. The product may be legal, as constructed and marketed. It may technically comply with regulations as they have been understood and applied to date. But the product is not fair

[9] Acting Comptroller Michael J. Hsu, "Reforming Overdraft Programs to Empower and Promote Financial Health," December 8, 2021; and Acting Comptroller Michael J. Hsu, "Don't Be the Last Banker to Update Your Overdraft Program," American Banker, March 28, 2022.

[10] OCC Bulletin 2023-12, "Overdraft Protection Programs: Risk Management Practices," April 26, 2023.

[11] OCC News Release 2023-71, "OCC Assesses $60 Million Civil Money Penalty Against Bank of America Related to Bank's Overdraft Program," July 11, 2023.

[12] Consumer Financial Protection Bureau, "CFPB Proposes Rule to Close Bank Overdraft Loophole that Costs Americans Billions Each Year in Junk Fees," January 17, 2024.

[13] See note 8. See also Michael Moebs, "Overdraft Prices Tumble While Volume Soars," Moebs $ervices, March 26, 2023.

when over-used by certain consumers. As with overdrafts, having a clear sense of where this fairness line is *prior to* the development and launch of such a product can help a bank avoid compliance risk issues down the road, when the product has grown and consumer harms are more apparent.

<u>Multiple notions of fairness</u>

Fairness is not unidimensional. Multiple notions of fairness can and do exist. Sometimes they are complementary; sometimes they are in tension with each other. In developing an internal sense of fairness, a bank should be aware of how multiple notions of fairness interact and that achieving fairness along one dimension does not mitigate unfairness along other dimensions.

Let's start with the familiar: the concepts of disparate treatment and disparate impact serve as anchors to our fair lending laws and regulations. Disparate *treatment* occurs when a lender's policies or practices treat credit applicants or borrowers differently because of their race, ethnicity, religion, sex, or other prohibited characteristic. Disparate *impact* occurs when policies or practices that are neutral on their face result in disparities that disadvantage certain credit applicants or borrowers. Mitigating one does not automatically result in mitigating the other. To comply with fair lending laws and regulations, banks must mitigate both.

In some situations, however, it is not possible to *fully* achieve multiple notions of fairness simultaneously. Here, lessons from artificial intelligence (AI) and machine learning (ML) are instructive. AI and ML systems can present unique bias and discrimination challenges. For instance, special attention needs to be paid to biases in training data and in supervised and reinforcement learning, especially in the consumer lending context.

Even if an AI or ML system could achieve complete colorblindness in decision making at the *individual* level, however, it would still yield unfair outcomes at the *group* level if baselines across groups differ. The AI community has been grappling with this "impossibility theorem" for some time in the criminal justice context.[14] Banks and regulators need to consider this and should prepare for similar discussions with regards to consumer banking.

Conclusion

Compliance has generally been viewed as a means to an end—i.e., through compliance with laws and regulations, the goal of fairness in banking can be achieved. Through this lens, the applicable laws and regulations set the bar for fairness in the banking system. If banks comply, fairness should follow. Fairness, in other words, is both the goal and an output.

Today, I have talked about flipping the script and encouraging banks to use fairness as an *input* to help guide their compliance risk management programs. By elevating fairness, banks can improve their ability to anticipate and adapt to emerging compliance risk issues. The stronger a bank's ability to do that, the less it will need to look over its shoulder at its regulators and the more degrees of freedom it will have to innovate and create banking products "for the people."

[14] Kailash Karthik Saravanakumar, "The Impossibility Theorem of Machine Fairness: A Causal Perspective," January 29, 2021.