AMERICAN BANKER

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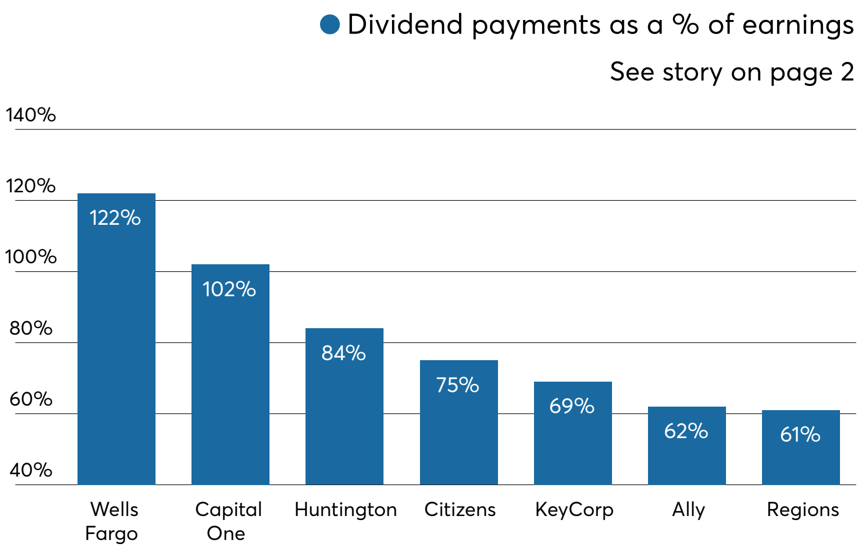
Who's on the bubble?

Two big banks would exceed a Fed requirement that third-quarter dividends stay at or below the average payout from the prior four quarters, based on current projections*



Source: Janney Montgomery Scott (*2Q 2020 figure is a consensus estimate)

dailybriefing

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STRESS TESTS

Did Fed get it right on shareholder payouts?

By Hannah Lang, Allissa Kline and Jon Prior

June 26, 2020

WASHINGTON — The Federal Reserve's cap on shareholder payouts by big banks immediately launched a second-guessing game within the banking industry, with many holding out judgment until the path of economic recovery from the pandemic is more certain.

In the publication of its annual stress-test results, the Fed said it would require big banks to suspend share repurchases during the third quarter and limit dividend distributions to the levels banks paid out in the second quarter. Those distributions could also be limited further, the Fed said, depending on each individual bank's earnings results.

The central bank is also requiring the 34 banks with more than $100 billion of assets that it tested to resubmit their capital plans later this year.

As part of its normal stress-testing cycle, the Fed also tested banks against hypothetical economic models of recovery from the pandemic as a supplemental exercise to its typical stress testing regime to account for the impact of COVID-19 on bank capital.

While the results of those "sensitivity analyses" showed that banks would maintain the regulatory minimum capital requirements under different levels of economic stress, several banks were said to have approached the 4.5% minimum common equity Tier 1 capital requirement under the most severe scenarios. That revelation raised questions about whether the Fed should be doing more to ensure that banks hold onto capital.

"The board ended up taking a middle position of modest restrictions now while expressing caution about the future," said William Lang, managing director at Promontory Financial Group. "This runs somewhat counter to the lessons of the last crisis, which were that it was preferable to conserve capital while banks are in a stronger position."

Michael Barr, who worked on the Dodd-Frank law as former assistant secretary for financial institutions at the Treasury Department under the Obama administration, said that the central bank should have barred dividends altogether, like the agency did for stock buybacks.

He added that the analysis done for justifying continued dividends was too backward-looking and did not take into account the possibility that the economy has not yet even hit the recovery stage as some areas are dealing with a surge in new COVID-19 cases.

"We're in the middle of an absolutely unprecedented global pandemic and economic collapse," Barr said. "It doesn't make sense to me. Now is the time that you want banks to raise additional capital to make sure they are even more resilient. At a minimum, the Fed should not be permitting dividend payments."

That sentiment was echoed by Fed Gov. Lael Brainard, who voted against allowing banks to continue paying dividends to shareholders, saying in a statement that she did "not support giving the green light for large banks to deplete capital."

But others viewed the Fed's actions as judicious, and felt that the regulator went plenty far in ensuring that banks will be able to withstand a downturn of any scale.

"It's hard not to look at what the Fed did and view it as prudent," said Darren King, the chief financial officer of M&T Bank in Buffalo, N.Y., one of the banks tested against the Fed's scenarios.

King would not say whether the Fed's actions change anything about the $124.6 billion-asset bank's own plans for buybacks or dividend payouts, but he did say the decision to cap dividends will either be prudent or "with any luck, the pain of the pandemic won't be as severe and balance sheets will be strong and ultimately we will have excess capital to distribute to shareholders at a later date."

Banks will be able to disclose their stress capital buffer requirements and planned capital distributions on Monday after the markets close, if they choose to do so. But because banks will need to go through another round of stress testing later this year, some are still weighing whether to release that information.

King said M&T Bank is undecided about whether it will report any stress-test information on Monday.

"We've got our stress capital buffer number, but we're going to go through another process basically in 90 days and in the interim we know we can't buy back stock or change dividends other than to decrease them," he said. "So I'm not sure what else there is to say, and therefore I'm not sure if we will say anything at all."

Wells Fargo, Citigroup, U.S. Bancorp, Fifth Third Bancorp and Citizens Financial Group declined to comment on the Fed's decisions. In March, as economic

AMERICAN BANKER.

Established 1836
One State Street Plaza, 27th floor, New York, NY 10004
Phone 212-803-8200 AmericanBanker.com

Editor in Chief Alan Kline 571.403.3846

Managing Editor Dean Anason 770.621.9935

Executive Editor Bonnie McGeer 212.803.8430

Washington Bureau Chief Joe Adler 571.403.3832

Executive Editor, Technology
Penny Crosman 212.803.8673

BankThink Editor Rachel Witkowski 571.403.3857

Community Banking Editor Paul Davis 336.852.9496

Contributing Editor Daniel Wolfe 212.803.8397

Digital Managing Editor
Christopher Wood 212.803.8437

Copy Editor Neil Cassidy 212.803.8440

Reporters/Producers

Laura Alix 860.836.5431, Kate Berry 562.434.5432

Miriam Cross 571.403.3834

Jim Dobbs 605.310.7780

John Heltman 571.403.3847, Allissa Kline 716.243.2679

Hannah Lang 571.403.3855

John Reosti 571.403.3864, Gary Siegel 212.803.1560

Jackie Stewart 571.403.3852, Kevin Wack 626.486.2341

uncertainty mounted, all five were part of the group of banks that temporarily suspended share repurchases through at least the end of the second quarter.

Because the Fed did not disclose how individual firms performed in the sensitivity analyses and instead published the results in aggregate, many were left guessing as to which banks performed better than others.

That could play into bank decisions on whether to publish their stress capital buffer requirement next week.

That buffer, which was finalized in March, calculates a bank's stress capital buffer as the difference between a bank's starting and projected capital ratios under the "severely adverse" stress-test scenario, and factors in a bank's common stock dividends as a percentage of risk-weighted assets.

"My best guess would be that most banks will feel the need to disclose the stress-capital buffer themselves," said Lang. "Holding back on disclosure might lead market participants to infer that there is a problem even though banks are in a strong capital decision. This could be worse than a bank reporting stress-capital buffers that are larger than its peers."

The Fed's decision not to disclose how individual banks fared under its hypothetical coronavirus-related scenarios was met with criticism from many who felt that the sensitivity analyses lacked transparency. Barr called that decision a "mistake."

"It didn't make sense to hide details of the individual firms," said Barr, who is now dean of the Ford School of Public Policy at the University of Michigan. "The stress tests were a lot less useful than they should have been in helping us understand the health of the financial system."

In a speech last week, Fed Vice Chairman for Supervision Randal Quarles explained that the Fed decided to release only the aggregate results of banks tested partly because the agency did not give firms advance notice about the scenarios it would be testing the firms against.

"I don't think the Fed wanted to use that sensitivity analysis in a public way to address any one firm," said Adam Gilbert, a partner at PwC. "I also think they would not necessarily want to single anyone out related to the pandemic sensitivities, because that can become a self-fulfilling prophecy, so you want to be careful about that."

Meanwhile, some industry observers were hoping to get more clarity from the Fed about capital plans and the pace of future dividend payments. Instead, the central bank is going to monitor capital plans every quarter even as new capital plans are approved.

That means "questions about dividends are going to remain an overhang" and the resubmission of those capital plans could be a negative sign for dividend payments beyond the third quarter, said Brian Kleinhanzl, an analyst with Keefe, Bruyette & Woods who covers big banks.

Kleinhanzl said he doesn't expect the Fed to release new scenarios until late in the third quarter or make decisions about the resubmitted capital plans until after the November presidential election takes place.

What those scenarios ultimately look like remains unknown for the time being.

"What happens in the economy between now and [later in the third quarter] is of utmost importance," Kleinhanzl said. "That will have some influence on how stressful these scenarios are."

Analysts at Robert W. Baird and Co. said in a note to clients Friday that the Fed is likely to keep a "short leash" on any dividend plans submitted by the banks going forward. Baird analysts expect most banks will hold dividends at the status quo, but they said "a dividend cut seems likely" for Wells Fargo.

Wolfe Research analysts along with analysts from Janney Montgomery Scott calculated that only two banks, Wells Fargo and Capital One, currently had dividend levels above what the Fed would permit and stood the highest chance to make cuts.

"While bank dividends appear largely safe for now, we would note that the group has not yet been given the 'all clear' as limitations will be revisited on a quarter-by-quarter basis," the Wolfe Research analysts wrote.

The Fed's message regarding dividends is clear, said Christopher Marinac, an analyst at Janney Montgomery: Current earnings at individual banks have to support current dividends payouts.

"It's kind of like the Fed is reminding us of what we really should be focused on — what are the current earnings and where are we with this recession?" he said. "And right now it's very open-ended."

CFPB

Supreme Court strikes down CFPB leadership structure

By Kate Berry and John Heltman
June 29, 2020

The Supreme Court ruled on Monday that the single-director structure of the Consumer Financial Protection Bureau is unconstitutional, but stopped short of disbanding the agency altogether or invalidating the Dodd-Frank Act that created it.

In a split 5-4 decision written by Chief Justice John Roberts, the high court found that the agency's structure vests too much power in the hands of one person, and that the president has broad authority to appoint and remove agency heads. The ruling, which gives a sitting president the ability to fire a CFPB director without cause, has far-reaching implications for other independent agencies with single-director structures such as the Federal Housing Finance Agency.

"The CFPB's single-Director structure contravenes this carefully calibrated system by vesting significant governmental power in the hands of a single individual who is neither elected by the people nor meaningfully controlled (through the threat of removal) by someone who is," Roberts wrote.

The ruling eliminates the so-called "for cause" provision in Dodd-Frank but keeps the rest of the law and the agency intact. There is no impact on its past nine years of rulemakings, decisions and enforcement actions.

Roberts wrote: "The CFPB's structure has no foothold in history or tradition. We therefore hold that the structure of the CFPB violates the separation of powers. We go on to hold that the CFPB Director's removal protection is severable from the other statutory provisions bearing on the CFPB's authority. The agency may therefore continue to operate, but its Director, in light of our decision, must be removable by the President at will."

The ruling could have far-reaching implications for dozens of agencies including the FHFA. It also means that CFPB Director Kathy Kraninger can be fired at any time by the president.

The high court's decision could also shine a new light on agencies overseen by boards or commissions that are structured with some measure of independence from the president, particularly the Federal Reserve, whose members are appointed to 14-year terms and are not removable by the president except for cause.

CREDIT QUALITY

Question looming over bank earnings: Will deferred loans be paid back?

By Jim Dobbs
June 25, 2020

Whether the economy remains weak, hampered by continued rapid spread of the coronavirus, or slowly comes back to life as Americans learn to safely venture out again, community and regional banks are likely staring at several quarters of elevated loan-loss provisions, according to investment analysts.

The pandemic-imposed recession is battering the retail, hospitality and energy sectors — and broadly sales for a range of other businesses — leaving banks to conservatively assume that more borrowers will struggle to make loan payments, even if the economy gradually recovers in the second half of 2020.

"Bottom line," D.A. Davidson analysts said in a June report, "we expect to see continued reserve build over the balance of the year, with a hand-off to more elevated" charge-offs later in 2020 and into next year.

When second-quarter earnings calls get underway in July, executives at community and regional banks are likely to field an abundance of questions about credit quality. The hope is that, by mid-July, bank executives will be able to shed meaningful light on what lies ahead based on the performance of their loan books and their assessments of customer sentiment and expectations.

One telling sign could be the direction of loan deferrals. Late in the first quarter and early in the second, banks agreed to defer scores of commercial loan payments, often for 90 days. Will those borrowers be able to resume payments on those loans? Will they seek to extend deferrals? Or will they throw in the towel on their businesses, forcing banks to charge off more loans?

"Almost everyone believes the amounts are as high as they've ever been, and so the most important question in the industry right now is at what rate those deferrals translate to losses," said Joseph Bonner, founder of the consultancy Community Bank Advocates and a former bank CEO.

Even with some clarity on the deferral front, Bonner said, most banks would be wise to brace for continued economic weakness and a choppy recovery. Provisions soared in the first quarter. He anticipates further increase for many banks in second-quarter results. He noted that Federal Reserve officials recently predicted that unemployment, currently above 13%, could still hover nearly 10% by the close of 2020.

"I believe that the more conservative view is the prudent one," Bonner said.

Banner Corp. in Walla Walla, Wash., for one, in June provided an updated look at its anticipated second-quarter provision expenses. It said provisions could range from $27 million to $36 million. At the midpoint, that would exceed the average analyst expectation at the start of June by $12.4 million, according to Stephens analyst Gordon McGuire. The Banner projection, at the midpoint, includes $6 million for charge-offs and impairments.

The $12.8 billion-asset Banner recorded a provision of $21.7 million for the first quarter, more than 10 times the year-earlier level. The bank said proactive downgrades on modified and at-risk loans — based on economic forecasts that weakened since the first quarter — drove the projected second-quarter increase.

"We anticipate more banks will guide toward higher provisions," said Janney analyst Tim Coffey.

First Bancorp in Southern Pines, N.C., disclosed on June 17 that it recorded $18 million in loan-loss provisions in April and May, or more than triple what it set aside in the first quarter. The $6.4 billion-asset company has granted deferrals for loans representing about 17% of its overall portfolio on March 31.

The biggest credit quality problems are expected to lie in industries hardest by the government-imposed lockdowns that closed consumer-driven businesses to slow spread of the virus.

But expectations that weaker credit will spill into other areas are mounting and may continue to do so, particularly if the economy fails to rebound in the third quarter.

Among the largest and most battered is the energy industry, where demand for fuels plummeted as the pandemic led to travel cutbacks and lower demand for the power used to run businesses and industrial operations. More than a dozen U.S. oil-and-gas producers filed for bankruptcy in the second quarter, and the law firm Haynes and Boone, which tracks Chapter 11 filings, expects more to come. Oil prices have recovered some in recent weeks as transportation increases, but prices remain well below pre-pandemic levels.

"It is reasonable to expect that a substantial number of producers will continue to seek protection from creditors," Haynes and Boone said in a report. The $133.5 billion-asset Regions Financial in Birmingham, Ala., for example, says it is obvious that energy is vulnerable.

"We look at the energy book [and] we know there's stress. We know there's going to continue to be stress," Barbara Godin, Regions' chief credit officer, said at a June conference. "Glad that the price of the barrel of oil has come back up, but notwithstanding, it is going to shake some players out. So all eyes on that portfolio."

Extensive federal stimulus packages, notably including the Paycheck Protection Program for small businesses, could minimize the overall damage. Banks anticipate that the bulk of PPP loans will be converted to government grants. Should that funding bridge commercial borrowers from current economic weakness to recovery, and should a substantial share of clients that sought loan deferrals resume payments in the third quarter alongside increased business activity, many banks could avoid steep credit losses that would otherwise imperil full-year profits.

"In the third quarter, we could see the PPP stimulus run out, a lot of the loan deferrals could end, a lot of the unemployment benefits will run out," John Corbett, the CEO of the $35 billion-asset South State in Winter Haven, Fla., said in an interview with American Banker. "It feels like the morphine will wear off in the third quarter, and then we as an industry will know where we are."

At the same time, said bank investor and Iron Bay Capital President Robert Bolton, many banks are now flush with deposits, as both businesses and consumers drew on credit lines and tapped emergency government programs to bolster liquidity. Many parked the money in banks, viewing them as safe havens. With excess funding, banks can allow higher-cost deposits to gradually exit, offsetting the negative impact of ultralow interest rates on loan yields. The Federal Reserve lowered rates to near zero to stimulate borrowing and economic activity, but rate drops often dampen banks' interest income and hurt profit margins.

"So in addition to credit, there will be a lot of eyes on PPP, on the impact of government stimulus and on banks' ability to maintain their margins," Bolton said. "The very good news is that banks went into all of this exceptionally well capitalized. I think, as an industry, they can and will weather the tremendous disruption that we've seen."

WEALTH MANAGEMENT

Banks continue to embrace robo advisers (even if customers don't)

By Miriam Cross

June 26, 2020

About a year ago, the digital investment products team at Citizens Bank noticed that several fintech providers of robo advice had introduced high-yield cash accounts.

Citizens' takeaway: Most of these were companion accounts, with little or no integration between the cash and investment sides. The Providence, R.I., bank decided that instead of introducing a product where rate hoppers would go for the best return, it would build a digital adviser that tied together both cash and investing, in a bid to reach customers who were banking but not yet investing with them.

"We're not assuming the customer is ready to invest all of their investable assets immediately," said Kate Magaram, vice president of growth and SpeciFi product manager at the $176.7 billion-asset Citizens. SpeciFi is the named shared by a pair of robo-adviser programs the bank offers, one for individual retirement accounts and the other a new cash/investing hybrid for taxable accounts.

The consulting firm Oliver Wyman found that about 80% of the top 15 consumer banks offer their clients a robo-adviser option right now.

For banks, adding robo advice to their suite of services "is increasingly table stakes," said William Trout, head of wealth management at Celent.

Citizens Bank and Citigroup are among the banking companies that have infused resources and energy into in-house robo advisers recently, despite overall tepid demand for such products.

There are several reasons banks should consider building a robo adviser, mainly for long-term rather than short-term strategizing.

One major goal is to stem the flow of assets toward independent robo advisers such as Betterment or Wealthfront while catering to younger, tech-savvy clients who have thousands or tens of thousands to invest rather than several times that.

But depending on the bank, the target audience isn't limited to customers in their 20s and 30s. Some banks are looking beyond millennials to consumers in all age groups who are seeking a modest return on their money.

With deposit rates being so low, "Customers need more growth to achieve long-term goals," said Aaron Fine, partner and head of retail and business banking practice, Americas at Oliver Wyman.

Competition is rising from the robo side as well. Platforms such as Betterment, Wealthfront and Ellevest have either set up — or have imminent plans to debut — their own banking services.

Banks are hoping that their customers will still be more likely to stick with their offering.

"There's a certain level of convenience that comes from having your relationship with one place, and a certain level of trust that people have with their banks versus a Betterment or Wealthfront," Fine said.

Despite economic uncertainty during the pandemic, the need for help with investing hasn't waned. Automated rebalancing takes the emotion out of investing for clients worried about playing a volatile market.

"We have seen self-directed investors, the type that goes to robo advisers, a lot more active in the pandemic," Trout said.

Still, even as banks have increasingly rolled out these automated platforms over the last few years, demand among customers has been muted.

"I think the adoption is fairly low, frankly," Trout said. "They are targeting a segment that doesn't have a lot of disposable income. There are also problems of inertia and the need to save for a rainy day, so a lot of investors don't get around to actually setting anything up."

But when banks' robo advisers are a defensive strategy, that's not necessarily a problem.

"As long as the option is there and the customer doesn't leave the bank, the bank is happy," said Trout. "This is also about keeping the customer in a relationship with the bank 20 years from now when they have a mortgage and need insurance and have kids they want to send to college."

Two banks are forging ahead with relatively new robo services: Citizens Bank, which introduced SpeciFi Save & Grow in late April, and Citi, which debuted Wealth Builder in late January.

Citizens Bank: Cash for today, growth for the future

A total of 21 focus groups and three quantitative studies that Citizens Bank conducted in 2019 revealed that customers wanted help with investing for their futures beyond their 401(k) accounts.

This propelled the digital investment products team to build on SpeciFi, the digital investment advice platform it launched in 2017 with the investment platform SigFig, to create the next iteration: SpeciFi Save & Grow. SigFig serves as the bank's technology partner, while National Financial Services is its custody and clearing partner and executes its trades.

The original SpeciFi is now available as

SpeciFi IRA, where customers can invest in traditional, Roth and rollover IRAs. SpeciFi Save & Grow layers a cash component onto the investment account.

Customers can decide how much money they want to tuck away on the cash side (recent yield: 1.25%) for near-term needs. Any excess funds, such as interest, dividends or new contributions, will be automatically swept to the investment side on a daily basis to help meet long-term goals. The minimum investment requirement is $2,000.

"We heard from customers that above everything else, they wanted to make sure they had that control," said Magaram. "Some think about the cash piece as an emergency fund, but for others it was where they wanted to save for near-term purchase or just money they are not ready to invest. We wanted to recognize the cash portion could be used for different purposes based on the customer."

Citizens declined to supply exact figures, but said it has seen an 80% increase in the proportion of customers setting up automatic contributions in Save & Grow compared with those who have automatic recurring contributions in non-Save & Grow SpeciFi accounts. Customers can transfer money from any eligible bank account linked to Citizens Bank Online, not just Citizens Bank accounts. The bank also said the growth during the pandemic, even before Save & Grow was launched, was particularly strong.

"I'm sure we're seeing people invest with us now for a variety of reasons," Magaram said. "Many probably see an opportunity to get into the market during this period of volatility, while others may see wisdom in having their investments professionally for a low fee or just want to take the emotion out of investing. With Save & Grow, we've seen customer interest in utilizing both the investing side and the cash side, which I suspect reflects that it feels more important than ever to have an emergency fund or a cash buffer."

Citi: Aiming for emerging affluent clients

Citi introduced Wealth Builder at the end of January, with a minimum initial investment of $1,500 and no advisory fees for Citi Priority and Citigold clients' first accounts.

After answering a questionnaire that assesses their risk tolerance, goals and current savings, customers will be matched with one of six portfolios. Wealth Builder will automatically rebalance portfolios, which, like Save & Grow's portfolios, are made up of exchange-traded funds.

Citi partnered with the digital wealth platform Jemstep to create Wealth Builder, which is one of several recent initiatives aimed at Citi Priority clients, including the expansion of financial-planning services from Citi Wealth Advisor.

"Citi Wealth Builder is one way for us to up the ante in wealth, by making retirement investing simple as we enhance the value proposition for our emerging affluent clients," John Cummings, head of Citi U.S. consumer wealth management, said in an email.

One of the target audiences is Citi Priority clients who are young, digitally savvy and draw a high income, "to help them deepen relationships with us as they grow their wealth and become Citigold clients," he said.

Like the team at Citizens, Cummings says Citi customers will find value in keeping their deposits and investments in one place. Although Citi has temporarily dialed down marketing of Wealth Builder during the pandemic, the bank reports that assets under management average about $10,000 per account so far.

"People tend to panic during volatility and pull out money from the market, especially if they don't have an adviser, which can damage their finances long term," Cummings said. "Citi Wealth Builder gives people an option to stay invested in the market with the peace of mind knowing that their account is being monitored."

COMMUNITY BANKS

Northeast Bank in Maine strikes deal to sell its PPP loans

By John Reosti
June 26, 2020

Northeast Bank in Portland, Maine, has agreed to sell nearly $458 million in Paycheck Protection Program loans.

The $1.2 billion-asset bank said in a press release Friday that the buyer, The Loan Source in New York, has deals in place to buy another $815 million in PPP loans from other lenders. Northeast did not identify the other sellers.

Northeast said it would record a $9.8 million gain in the second quarter. It also agreed to serve as a correspondent bank to facilitate The Loan Source's pledge of PPP loans to the Federal Reserve Bank of Minneapolis under the central bank's liquidity facility.

Northeast said it expects to generate $2.9 million in revenue over the next two years for the correspondent services and half of the net servicing income.

Those numbers could climb.

The Loan Source "is talking to a lot of banks" about buying their PPP loans, said Rick Wayne, Northeast's president and chief executive.

For Northeast, the "big driver" behind its decision to sell was the complexity of servicing the loans, Wayne said.

"We looked at eight demos of software platforms for PPP servicing," Wayne said. "We were thinking, 'How is this going to integrate with our core system? How much resources are we going to have to divert to train people? And can we do it correctly?' It's very specialized."

While the Small Business Administration, which is administering the program with the Treasury Department, recently released a simplified forgiveness application, bankers have complained that the agencies have left them in the dark on how detailed the review process will be, as well as how to submit approved applications.

Confusion surrounding forgiveness has driven banker groups to press for automatic, or blanket, forgiveness for small-dollar loans. In all, lenders have made more than 4.7 million loans for $517 billion under the program.

The PPP provides forgivable loans of up to $10 million for businesses with 500 or fewer employees impacted by the coronavirus pandemic.

ACAP SME, a firm created exclusively to service Paycheck Protection loans, will service the loans that The Loan Source buys from other lenders. Efforts to reach an ACAP spokesman were unsuccessful.

Northeast reported having $475.5 million in PPP loans on June 24. The bank plans to sell any other PPP loans it makes to The Loan Source.

STATE REGULATORS

Referendum on data privacy coming to California in November

By Kevin Wack
June 28, 2020

It was just two years ago that California passed a groundbreaking data privacy law. Now the state's voters have a chance to expand its protections.

The latest proposal, known as the California Privacy Rights Act, would create a state agency to serve as a privacy watchdog and would offer more rights to consumers. It would also create a raft of compliance work for banks and other companies, especially tech firms that rely heavily on users' personal data.

The financial services industry would retain limited exemptions that were included in the earlier law.

The measure was approved last week for the statewide ballot in November after its backers obtained more than 623,000 signatures.

"We've come a long way in the two years since passing the landmark California Consumer Privacy Act," Alastair Mactaggart, the lead backer of both measures, said in a press release. "But during these times of unprecedented uncertainty, we need to ensure that the laws keep pace with the ever-changing ways corporations and other entities are using our data."

Californians for Consumer Privacy, the group that Mactaggart founded, obtained enough signatures in 2018 to put a sweeping data privacy proposal onto the statewide ballot. Instead, the group agreed to a last-minute compromise, passed by the state legislature, that took effect in January of this year.

This year, Mactaggart's group appears more likely to carry the fight to the ballot box. Polls show strong public support for data privacy protections. While the ballot initiative will likely be opposed by industry groups, it remains to be seen how much money big tech companies in Silicon Valley will be willing to put into an opposition campaign.

Banks and credit unions that operate in California have already invested considerable time and money to comply with the 2018 law. Financial industry lawyers said that the latest measure, if it becomes law, will require more investments.

"It's a pretty significant overhaul," said Nate Taylor, a lawyer in the privacy and data security practice at Morrison & Foerster. "Very little is left unchanged."

The proposal would create a watchdog, called the California Privacy Protection Agency, that would be governed by a five-member board and have the authority to enforce the law.

New protections for California's nearly 40 million residents would include the right to correct inaccurate personal information and the right to opt out of advertiser use of precise geolocation data.

"I do think this initiative provides greater rights to consumers," said Amanda Lawrence, a lawyer at Buckley LLP.

Banks would maintain an existing exemption for personal information collected, sold or disclosed pursuant to the Gramm-Leach-Bliley Act, a 1999 federal law. An exemption for personal data gathered during the course of business-to-business communications would get a temporary extension. The bulk of the ballot initiative would take effect on Jan. 1, 2023.

The proposal would bring the nation's largest state into closer alignent with the European Union's data privacy requirements, according to lawyers at Davis Polk & Wardwell. In a written analysis, the Davis Polk lawyers called the smaller gap between those two regimes a boon, but not a panacea, for firms that already comply with EU rules.

Under California's existing law, state residents have the right to obtain copies of their personal information from specific companies, as well as the right to demand the deletion of their data. The two-year-old law has served as the model for legislative proposals on data privacy in roughly 15 other states, according to a 2019 analysis by the law firm Baker Hostetler.

Efforts to pass a federal data privacy law have long been stymied by disagreements that pit industry groups against privacy advocates and state regulators. One key sticking point is whether national standards should serve as a ceiling or a floor for state regulation.

ONLINE BANKING

With virus hastening online push, does Amazon-like future await banks?

By Bloomberg News
June 26, 2020

As Spaniards endured one of Europe's most stringent pandemic lockdowns, Banco Santander's digital-only Openbank did roaring business. Its brokerage client base expanded 58% in the first four months of the year and trading in shares, ETFs and warrants on its platform more than doubled.

The confinement has made people digital beings "by decree," says Ezequiel Szafir, Openbank's CEO. With that trend likely to continue, he sees banks of the future looking increasingly like Amazon.com — with online storefronts for financial products.

"Amazon took something that's real, which is retail, and simply made it digital," Szafir, a former Amazon executive hired in 2015 to oversee Openbank's new online platform, said in an interview in Madrid. "We're trying to do the same transformation in banking."

Businesses reviewing post-COVID-19 strategies are finding that online activity — from shopping and gaming to banking and social networking — that was shaking up their worlds even before the pandemic, has flourished. For retail banking, a survey by McKinsey & Co. from mid-April found a jump of as much as 20% in digital-channel use across Europe. More than one in five customers in Spain and Britain tried online banking for the first time.

Spending trillions

That's giving a new impetus to banks' online push. They're looking to speed up plans to move creaking legacy platforms onto the cloud, a slow and often costly process. Some are also building standalone online platforms from scratch or using off-the-shelf solutions designed by fintech companies, which may be faster and cheaper.

"Many banking groups are taking a hybrid strategy combining the effort of transforming the original bank and also developing a neobank or, at least, some speed boats, sometimes in alliance with fintech," said Francisco Uria, head of Europe Middle East and Africa financial services, banking and capital markets at KPMG.

Banks globally will spend about $1 trillion over three years to take more of their operations online, according to an Accenture report. Spending on digital transformation has been led by U.S. banks, with JPMorgan Chase earmarking $11.4 billion a year.

"It's the only way they'll remain competitive," said Antony Jenkins, who was the CEO of Barclays Bank between 2012 and 2015 and is now chairman and founder of 10x Future Technologies. "They're already under pressure because return on equity is poor. They have to compete with fintech and big tech. They need to get more agile, get these functionalities onto the market quicker."

Survival question

Europe's banks can expect revenues to fall by more than 40%, which means it will take them four years to get back to pre-COVID levels, the McKinsey report found. With a rise in interest rates from historic lows delayed by the crisis, survival will require cutting costs. That will mean shutting down many more branches, slashing jobs and taking the show online.

The cost-to-income ratio for traditional banks is 55% to 60% compared with half that for online challenger lenders. Santander Chairman Ana Botin told investors Openbank's expansion would allow it to reach a ratio of 25%-35%, a level the entire group could attain in the long term. Santander's 2018 cost-to-income ratio was 47%, according to S&P Global.

Santander is plowing 5 billion euros ($5.6 billion) a year to put its legacy system data in the cloud, even as Openbank expands from Spain into 10 other markets. Botin calls it combining "supertankers" with "speedboats," and suggested in a speech last year that Openbank could eventually become the platform for "a significant part of our business."

The Spanish bank's peers are adopting similar strategies. In the U.K., Royal Bank of Scotland Group is working on digital business platform Mettle. Nationwide Building Society is working with 10x Futures technology while Lloyds Banking Group is doing something similar with the cloud-native digital platform provider Thought Machine. Goldman Sachs started Marcus by Goldman Sachs in Britain after launching it at home.

'Spaghetti party'

Digital metamorphoses may be easier said than done. Years of mergers have left banks with core platforms patched together from disparate systems — "a spaghetti party," as Szafir puts it. For many, it may be simpler to start from scratch. Unlike a legacy platform — like the plumbing in an old house — native cloud platforms are like newly-built homes where the wiring is exactly where it needs to be.

"I sometimes refer to banks as museums of technology because they've got every generation of hardware and software within them," Jenkins of 10x said.

The native cloud platform developed by Jenkins's company is being tried by banks such as Australia's Westpac Banking Corp and Nationwide Building Society in the U.K.

Part of the efficiency of the new platforms is their business model built around customers rather than products. That cuts out data overlap such as names and addresses that on legacy platforms appear multiple times for each banking product.

Open banking

The open architecture also paves the way for collaboration between financial institutions — something that's being encouraged by regulatory authorities, with the open banking initiative in the U.K. and the PSD2 directive in the European Union.

"We are moving toward where the bank is becoming a platform with an e-commerce marketplace," said Oliver Bussmann, a former chief information officer at UBS Group and now CEO of Bussmann Advisory AG in Zug, Switzerland. "You sell not only your own products, but also get commissions for selling services and products from third parties."

It's leading to a bifurcation in banking, says Jenkins. Larger lenders may choose to use their scale and brand recognition to become the distributors of products on their platforms, a bit like an Amazon. Smaller banks will become more like fintechs, specializing in certain products that they'll sell on others' platforms. Some, like Santander, will try to do both, Szafir said.

New systems are already being tested on segments. Openbank's platform is used for Santander Bank in Miami and could eventually be deployed for the U.S. unit as a whole. In the U.K., Lloyds is still in a testing stage with Thought Machine's Vault platform, said Zaka Mian, group director of transformation at Lloyds.

"We continue to test and learn to develop the confidence and certainty in the use of public cloud," Mian said in a phone interview. "But if you look at the very long-term, do I think that us and many other banks will end up on technologies like this? More than likely, I'd suspect."

CUSTOMER EXPERIENCE

JPMorgan will ditch customers who racially abuse its workers

By Bloomberg News
June 26, 2020

JPMorgan Chase is cracking down on racism by its customers. The bank is revamping a policy for dealing with abusive clients to include racism toward call-center employees as behavior that could warrant cutting ties with the customers.

"We are specifically calling out race to remind specialists that we will exit customer relationships when warranted regardless of how much money the customer has with us," Tom Horne, chief operating officer for card services at the bank, said in an interview Friday. "These are customers we don't need or want."

The bank cut ties with at least four clients who were racially abusive to call-center representatives in a two-week span after the video of George Floyd's killing by Minneapolis police went viral and led to protests nationwide, said Kisha Porch, who leads JPMorgan's call center in Tempe, Ariz.

"We've had examples where our customers have been inappropriate calling specialists names, using terms that are derogatory as it relates to race," said Porch, who said she has experienced racism from customers herself. "If those are escalated to me and if need to be, we will end a relationship with a customer."

JPMorgan's leaders have been working to adjust policies and procedures to help root out racism after a New York Times article in December described discrimination by its workers at an Arizona branch. Banks, which are increasingly being singled out for a legacy of systemic racism, are among companies addressing the issue across corporate America following public outcry after the killings of African Americans including Floyd, Breonna Taylor and Ahmaud Arbery.

The bank isn't alone in getting rid of clients over racism. Earlier this month, Amazon.com Inc. CEO Jeff Bezos posted on Instagram a screen shot of a profane, racist email he said he received from someone threatening to stop shopping with the retailer because of his support for Black Lives Matter, telling the person that "you're the kind of customer I'm happy to lose."

JPMorgan has long had a procedure for dealing with abusive, threatening or distressed clients, but it didn't explicitly include racial slurs as a form of abuse or specifically address how to handle racism, according to people with knowledge of the matter. If a customer is acting out, call-center workers are trained to ask them to stop and hang up if they don't.

The adjusted policy is meant to remind workers that the bank doesn't tolerate racism of any kind and that they should escalate instances where a client is racially abusive or insensitive to staff. A team of senior managers is empowered to make a case for JPMorgan ending its relationship with a customer if, after reviewing phone interactions, they find the client's behavior doesn't align with the firm's values.

"We know many people internalize those kinds of attacks," Horne said. "We do not want them doing that."

LAW AND REGULATION

Where FDIC, OCC chiefs differ on post-pandemic banking

By Brendan Pedersen
June 26, 2020

WASHINGTON — Two banking agency heads weighed in Friday on how to increase financial inclusion, illuminating key differences in how they may approach challenges left in the wake of the coronavirus pandemic.

The panel, featuring Federal Deposit Insurance Corp. Chairman Jelena McWilliams, acting Comptroller of the Currency Brian Brooks and hosted by Financial Health Network CEO Jennifer Tescher, focused on the question of how financial regulatory policy might — or might not — help shore up Americans' financial well-being once the pandemic subsides.

"The one-two punch of the pandemic and the resulting financial fallout has created significant uncertainty about the overall health of the economy, especially since we just don't have a good sense yet of how long it will take us to get back to quote-unquote, 'normal,' " Tescher said as she introduced the panelists.

Given the strength of the economic shock and the number of temporary government relief measures, such as bolstered unemployment benefits, that could expire as soon as next month, "this really is creating a perfect storm, certainly for consumers and potentially for the banks that serve them," Tescher said.

What follows is a summary of highlights from the discussion, which was conducted by videoconference.

Pandemic relief

In the early days of the pandemic, U.S. financial regulators had a loud-and-clear message for their supervised banks: Sit down with impacted customers and make it work, whether that means deploying temporary forbearance measures, restructuring loans, or even emphasizing small dollar lending.

Five months into the pandemic, that is still the approach being taken by both the FDIC and OCC. But the remarks of McWilliams and Brooks revealed significant differences in their oulooks.

Asked how the FDIC is advising its banks to weather the possibility of a perfect economic storm, McWilliams pointed to the agency's early steps to grant relief to both consumers and banks.

"Early on, we had issued a statement encouraging banks to proactively modify these loans — to go out and call their customers. Literally, we said, call your small-business customers, call your individual customers [and ask]: Did you lose a job?" McWilliams said.

McWilliams did not weigh in on the overall health of the economy during the panel. But she emphasized that the FDIC will continue to encourage relief to borrowers as long as the pandemic remains a factor in American public life.

"How long are we willing to go? However long is necessary," McWilliams said. "We will do what it takes to make sure that the consumers are not disproportionately impacted above and beyond, already, the shock to the economy that they're experiencing with the loss of wages."

Brooks said he would echo McWilliams' remarks on regulatory relief. But he also struck an optimistic tone about the economic outlook for the country, suggesting that he is hopeful that emergency relief measures will not need to remain in place for too much longer.

"The economic impact of the last three months, I'd emphasize, was human-caused," Brooks said. "We were confronting an unknown disease of unknown magnitude. And so we made the collective decision to turn off the economy."

Today, Brooks said, policymakers have a

much clearer idea what the health risks of the disease are. "And thus we've, in many states, narrowed the scope of those orders and had more targeted responses with the result that the economic data now looks very, very positive if it can be sustained."

"I think the issue for consumers is, can we get to a place where the economy's turned back on?" Brooks continued. "If we can, then I think the need for these extraordinary interventions will over time go away. And if not, then they won't."

Postal banking

The two regulators also commented on the potential reintroduction of postal banking, an idea that has gained steam in recent months in some left-leaning circles as one solution to the high cost of small-dollar lending for distressed consumers.

Brooks was not smitten by the idea, arguing that private-sector banking would be a more efficient and successful way to address the lack of access to the mainstream financial sector among low- to moderate-income Americans.

"I think anybody who's been in the Apple Store recently, and also been in the post office recently, knows that we do an amazing job in this country of harnessing market forces and bringing beautiful private-sector experiences to people who can afford it and have access," Brooks said. "Everybody wants to go to the Apple Store. Nobody wants to go to the post office."

"I would say if the most aspirational we can be is to consign lower income people to banking at the post office, that's a bad [idea], and I think we can do better than that," he said.

McWilliams appeared more open to the idea, depending on how a postal banking system is designed.

"I don't have enough information to tell you, oh, this would be great, or this would not be good at all," she said in an interview with American Banker after the panel, adding that the FDIC was responsible for implementing directives from Congress.

"In general, I think more competition is good. I do believe it's actually private-sector property [that] provides more agility in terms of competing than the government itself," she said. "But again, you know, we have real communities where a postal office may be the only thing there in a little town. So to the extent that that's the only way for them to access banking services, I would be open to it, but I would have to figure out what that looks like."

The future of artificial intelligence

The role of artificial intelligence across the financial system, whether in loan underwriting, regulatory compliance, supervisory work or beyond, has been debated fiercely for years. The limitations of the technology have made banks and regulators alike wary, given the potential for a biased algorithm or system to run afoul of fair- lending laws.

Still, both McWilliams and Brooks have emphasized the importance of technology and innovation in the banking sector, and they've both acknowledged the potential good that could come of widespread, well-regulated AI use in credit underwriting.

"There is a huge potential, with respect to artificial intelligence, to actually bring into the fold people who are not in the fold right now," McWilliams said during the panel on Friday, referring to the 45 million or so Americans without credit scores. "I think it's something that regulatory agencies have a lot more work to do in this space."

The FDIC chair also emphasized the difficulties of monitoring AI for signs of bias. "We're struggling with exactly how to supervise for AI biases," she said. "A lot of these companies are on the cutting edge of the technology, and our examiners need to develop skill sets to catch up in some cases."

Brooks, on the other hand, suggested that the potential for bias should not stop innovators from developing technology to improve existing credit underwriting infrastructure, or prevent policymakers from debating the potential tradeoffs of AI.

"Right now, the credit underwriting systems we have in this country — the very best of them — only capture about 60% of credit performance, meaning that 40% of the time, they're either approving loans that are going to default, or they've denied loans that wouldn't have defaulted," Brooks said. "So they're both overinclusive and underinclusive. They're highly, highly flawed."

Brooks predicted that if banks began deploying AI in underwriting today, two things would occur: More loans would be made to minority borrowers, and the disparity in loan approval rates between racial groups would grow.

"What I believe would occur when we start unleashing AI on underwriting is something that we need to debate as a society," Brooks said during the panel. "I believe we would significantly increase the number of minority loans, compared to the status quo. And I also believe that it is possible we will increase the statistical disparity between minorities and nonminorities."

Brooks suggested that the gap in approval rates would necessarily increase as more people entered the credit system, as many of those outside it today are disproportionately poor. "Those people do not get considered for loans today, so they're not in the statistics," he said.

"Once we bring them in, imagine a world where we could make a million new African American mortgages that currently don't get made," he said. "But imagine that the approve-deny statistical disparity goes up by 30 basis points. Is that a good thing or a bad thing?"

Brooks emphasized the need for a policy debate on the topic, but said that he would likely come out on the side of giving more credit to more people. "I would rather see more people getting credit, even if it means that there's a statistical artifact that makes it look unfair, than to consign those million people to a life of renting because I don't want a statistical disparity," he said.

BANKTHINK

Advice to debt collectors in pandemic times: Watch your language

By Jason Heller

June 26, 2020

Banks have braced for the initial wave of struggling borrowers in response to the coronavirus pandemic, but there is a second and potentially bigger wave ahead when it's time for collections.

According to McKinsey, up to one-third of jobs in the U.S. are "vulnerable," meaning subject to potential furlough, layoffs or rendered unproductive as a result of the pandemic.

Temporary loan forbearance and deferral programs have created some runway for banks to prepare for such a critical moment. But when these relief programs end, a new era of customer engagement and collections efforts must take shape.

During this time, well-managed collections can effectively unlock a "growth" lever, while acquisition and cross-selling slow to a crawl. Past crises have shown that banks with strong customer relationships that express empathy and flexibility with their customers will weather the storm better than ones that don't.

That all starts with the language used to communicate with customers — language that is both mindful and data driven.

First, financial institutions need to identify at-risk customers quickly and intervene early (if they have not done so already).

The swiftness of the coronavirus impact on the economy has left many customers in shock and trying to get a handle on their new financial situations. Banks that identify at-risk customers quickly, and use a multichannel approach to communications will keep these customers engaged and responsive during times of financial hardship.

This will allow banks to maintain these relationships well after the crisis is over. The key here is to enhance and protect customer experience to reduce charge offs and losses at the institution.

The pace of the collections crisis and call-center burden on creditors will come fast and furiously. Banks and creditors need to move beyond the "we're here for you" phase and put in place systematic, data-driven customer engagement capabilities within the pre-collections and early collections journeys.

Look for simple signals in data — such as changes in deposit flow and credit activity, or geographic location and industry employed — to create predictive segmentation.

Regulatory guidance recently issued in response to the pandemic provides significant leeway in offering loan modifications early, and reaching at-risk customers before they miss a payment. This is a critical window of engagement. Early intervention also provides more runway for a creditor to establish a preferential ranking in the order of creditors seeking payment.

Second, one of the biggest short-term challenges banks face is how to adopt a more mindful, context-sensitive and a tone-adjusted approach to branded communications — while still receiving customer payments and managing losses. Mindful messaging balances empathy with performance.

The language used during this time is crucial and doesn't need to be left to guesswork when it can be informed through data and artificial intelligence to balance effective messaging with empathy and sensitivity. Most messaging is written by a copywriter using pattern recognition and intuition. But natural language generation, a form of AI, can augment this experience, creating deeper human connections than a copywriter can alone.

If every creditor is using similar, generic language the message will never get through to desensitized customers. Prioritizing key pieces of information, and giving clear, precise next steps to customers will help them know what to do and when they need to do it.

For example, using AI-based language insights, phrases like "we're committed to giving you extra peace of mind" is more effective when communicating with customers in the pre-collections journey. Conversely, banks should refrain from using any language that conveys undue urgency or references the "news," which should be left to actual updates about the pandemic.

Third, don't put your call centers on the backburner.

Call-center employees are on the front lines of the customer experience and are critical in building, maintaining and repairing customer relationships.

Unfortunately, many call centers are seeing triple-digit surges in demand, even as some have made the herculean effort of shifting large groups of agents to work remotely.

As many banks are adopting digital banking now at greater speeds to meet the influx of customer demands, long hold times are creating poor experiences. What call-center employees say and how they say it can go a long way in creating or destroying customer loyalty and value.

To augment those efforts, many inbound calls should be directed to self-serve channels, which create significant cost savings and free up agents to manage more difficult cases.

The most innovative banks are already arming their call centers with smart routing to match specific customers to specific agents, and using AI-tested language to improve the performance of interactive voice-response prompts as well as call-center scripts.

This increases call deflection rates and drives adoption of self-service channels.

Lastly, preserving customer trust should be every bank's priority so when customers return to stronger financial footing, they know where to go for their next long-term loan or investment. Also, customers who feel a greater sense of loyalty now may be more willing to keep up with their payments, even if they need to do it in smaller increments over a longer period of time.

As this recovery takes shape, it's critical for banks to develop a clear understanding of consumer insights, new segmentation and a new baseline of acquisition, cross-sell and retention at scale.

However, as the current crisis ebbs and flows banks need to take it a step further to ensure their messages align to how customer expectations are shifting. The cost of getting this wrong means significant customer churn, increased delinquencies and sinking reputations (again).

Banks can successfully mitigate the incoming collections crisis and call-center surge by engaging early, identifying the most at-risk customers and pivoting to empathetic, mindful messaging by using AI and data-driven customer engagement. During a crisis of this magnitude, machines might actually be the ones to help banks be more human.

Jason Heller is president of Persado, a digital marketing company. He formerly was a partner and global lead of digital marketing operations and technology at McKinsey & Co. ❑

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