



FINANCIAL RISK MANAGEMENT AND SOCIAL MEDIA

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Social media have served as the bases for myriad 21st century tactics and strategies ranging from terror tracking and macroeconomic investment policies to TARP audits and financial products marketing. In fact, some financial industries such as insurance and credit card are, and it is anticipated that others, e.g. banking, will be, utilizing social media as part of the process of assessing whether and how they will do business with certain individuals and certain groups. Thus, social media already are part of the landscape of the financial risk management process. This has legal implications for the financial institutions using social media as part of their risk management process and for those persons or groups being assessed.

Traditional Financial Risk Management

Traditional financial risk management and underwriting rely upon independent single

subject analysis. A potential customer or insured directly or indirectly provides information that is analyzed by the lender or insurer in determining whether to do business with the individual and what interest rate to charge or what premium multiple to apply. There are a number of informational resources available, e.g. the application, the interview, credit reports, medical history and examination, court records and the like. In addition, an inspection report on or investigation of an individual also may be utilized to assess the intangibles, such as character, reputation, personal morals and habits. Social media now are being utilized as a source of information for assessing the intangibles.

The Data Mining Gold Rush

Network analysis software of various types and varying degrees of sophistication now enable interested observers of all types to

delve into disparate sources of information and identify connected individuals. Data aggregation based upon extracting information from sources such as telephone records, governmental and private entities and internet sources such as Facebook, Twitter and LinkedIn, offers up a treasure trove of information on individual habits and associations that may permit more efficient assessment of individual intangibles and may offer up indicators of future behavior that are potentially more reliable than a limited sampling of personal history.

The more sources there are to mine, the more data mining will be utilized to assess and predict individual behavior. With more than 400 (and counting) social media and networking websites in existence, it is a safe bet that the algorithms needed to mine them will keep on coming. This may in turn move significant aspects of the assessment

of intangibles in the risk management discipline away from the independent individual analysis model to the “influencer” model in which the behavior of one or a few highly influential social network users will be used to predict the future behavior of the other individuals with whom they have a social networking connection. Individuals’ personal integrity has long been judged by their associates. Soon, assessments of financial integrity may be tied to them as well.

Are We There Yet?

Some financial services firms reportedly are using software that has the capacity to identify risky borrowers by examining social networks and Internal Revenue Service records, and it is further reported that bank insurers are offering discounted rates to banks utilizing the software. Thus, with technological capacity and financial incentives in place, it makes sense to query whether or when the practice of utilizing social media to assess financial risk will become industry practice. The politic answer appears to be “not yet, but some day soon.”

Presently, most financial industries use fraud prevention as the portal to utilizing social network data to assess an individual’s financial integrity; however, it is reported that a growing number of banks and lenders are actively mining social media data for future use in credit risk analysis and current use in marketing. Most believe it will be three to five years before industry-wide usage of social media data to assess individual creditworthiness takes hold, because it will take that long to identify the relationship between social media behaviors and credit risks. On the other hand, social media behavior already is having an impact upon financial products marketing, and this begs the question of whether credit risk assessment is inherent in the process of deciding to whom a financial product will be marketed.

Is It Marketing or Underwriting?

Most larger financial institutions are engaged in some form of social media communication

and use it as a marketing tool for staying in touch with customers and promoting services or products; however, when social media information gathered by a third party is used to determine which financial products will be marketed to whom, arguably, the financial institution has utilized social media information to make a credit decision. For example, if a lender determines that based upon an individual’s social media data he or she is a candidate for home refinancing but not home equity products or is suitable for a secured credit card but not a high balance credit card and markets its products to the individual accordingly, then the lender has made a credit decision about the individual based upon social media data and conceivably has exposed itself to legal consequences, including those related to compliance with the Fair Credit Reporting Act.

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Fair Credit Reporting Act

The Federal Trade Commission, which is charged with enforcement of the FCRA, already has established that policing use of social media for data aggregation is within its jurisdiction. That was accomplished with its investigation of SOS Intelligence Corporation, which offers internet and social media screening and investigative services to employers, insurers and others. The FTC staff noted that the compliance obligations applicable in the customary consumer reporting discipline “apply equally in the social networking context” and went on to state that there are obligations to ensure maximum possible accuracy and to inform the businesses using the reports about their obligations under the FCRA. While the SOS Intelligence investigation’s application to employment decisions is specifically stated,

its probable application to credit assessment matters is obvious.

Financial institutions utilizing third party internet and social media data providers to gather information on potential customers must, among other actions, get permission from and make related disclosures to the individual to receive a copy of a social media background report and notify the individual in connection with any adverse action being taken. As well, the obligations to keep the report secure and to dispose of it properly also would apply.

Federal Legislation

Since 2009, federal legislative efforts have been underway to regulate the gathering and use of individual internet and social media data. The Data Accountability and Trust Act (DATA) of 2011 and the Personal Data Privacy and Security Act (PDPSA) of 2011 (S.1151), which currently seem to have the most traction in Congress, were introduced this summer. Each Act focuses on the security of personal electronic information (on an individual and national basis) as well as the regulation of data brokers, but their approaches are different.

DATA takes a compliance approach that would be enforced by the FTC and requires information brokers to establish security policies and to make accuracy, review and correction of information the foundation of their procedures. As well, information brokers are prohibited from obtaining or disclosing personal information under false pretenses. The PDPSA, on the other hand, makes fraud in connection with the unauthorized access of social media and other personal information a RICO predicate with criminal punishment and also emphasizes data brokers’ disclosure and security obligations while providing for civil penalties for violations of those standards. While there are notable differences between the approaches, it should be noted that each focuses on third party data aggregators and not entities gathering and using social media information for their own purposes. Thus,

the model utilized in the FCRA is replicated; however, state legislators could take an approach that imposes regulation and or compliance obligations on direct gatherers and users.

The Car Loan

A guy walks into a bank. He is a long time customer and applies for a car loan. The new branch manager takes the customer through all the appropriate protocols and in addition decides to look him up on some social media sites. Some of the customer's buddies don't seem to have regular jobs or be socially responsible. Based upon the social media information and the branch manager's predictions about the customer's possible future behavior as a borrower, the loan was declined.

Have the branch manager's actions created any FCRA exposure for the bank? The answer is "no," because the FCRA does not apply to direct gatherers and users of personal data. As well, there would be no exposure under proposed federal legislation aimed specifically at the mining of internet and social media information. On the other hand, should the branch manager's unofficial proto-

col be tacitly encouraged, and how prevalent is it in any particular financial institution? In any case, the branch manager should not be thrown under the bus. After all, the branch manager is in fact managing risk and protecting assets, behavior that is to be encouraged but also guided.

Stand By

We are at the end of stage one. The use of the internet and social media in the credit assessment of individuals is here. In fact, given the current availability of software capable of mining social media data at various levels, it would seem that the aggregation of social media information is a credit assessment tool that most major financial institutions can utilize without the need of a third party provider; although effective use may require a significant investment and still requires analysis and application to the particular customer being mined and assessed.

Reliable methods for validating the content and accuracy of internet and social media information still must be developed, but stage two in the utilization of social media data for individual financial risk assessment has begun. Time is still needed to gather the

appropriate sampling of internet and social media users' behaviors and to analyze them in juxtaposition to the credit history of borrowers sharing the same behaviors, but the work is well underway. Once the relationship models have been completed, this can lead to the development of a social media scoring system for individual credit assessment. Undoubtedly, that will require dedicated third party vendors to gather and monitor information on everyone's social media usage. They are here and working. Our scores are forthcoming.



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