



Bauerle's Bank Notes

Hack Attack

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A Financial Times columnist recently described 2014 as "the year of the hack." The year began with Target's data security breach and ended with Sony's falling prey to North Korea's cyber missile shot across the company's bow. One IT security expert opined the extortion threat of North Korea's action was notable less for its possibility than for its having actually been carried out.

The Wall Street Journal titled its Dec. 26 lead story, "U.S. Puts New Focus on Cyber Defenses." [\[i\]](#) The newspaper wrote that government and industry have both failed to build consensus on how to deal with cyber threats despite overwhelming evidence that the risk to the nation and its business infrastructure is significant and growing. "The government's approach is piecemeal Businesses, meanwhile, want more government help but also want to limit government intrusion." The article continued,

Business concerns about overregulation, among other factors, have played a role in the collapse of efforts in Congress in recent years to pass legislation that would create incentives for companies to take additional security precautions and share information. . . .

In the time that Congress tried and failed to pass broad legislation, intelligence officials elevated cyber threats to the top of the list of national security concerns.

More than any other industry, banking today depends on electronic processing of consumer and business financial transactions over the sieve-like infrastructure of the Internet. Even venerable JP Morgan Chase last year weathered an attack that compromised millions of consumers' information. Likely it will take a World Trade Center-scale calamity to galvanize public opinion to deal effectively with the issues surrounding Internet-based financial commerce. In the meantime, however, regional and community banks can focus on several aspects of their business that position them as an important part of the needed defense plan.

1. Strength in Numbers. The existence of nearly 8,000 banks in the U.S., located far and wide, provides a degree of redundancy that protects against long

term crippling of the nation's economy in the event of cyber attack aimed at the nation's largest institutions. The distributed computing model that became the Internet began as a Cold War expedient to mitigate the risk of a Soviet attack. More recently, Mellon Bank saved Wall Street's functionality following the World Trade Center's destruction. The Bank of New York, the other major processor of Wall Street securities settlements, had built its backup data center mere blocks from its primary center in lower Manhattan. Both centers were disabled by the attack. Even though BNY had made a hostile takeover bid for Mellon just three years earlier, Mellon processed BNY's trades, permitting the New York Stock Exchange to open six days rather than months after the event.

Regional and community banks need to build political awareness of their important role as a strategic resource. It would be difficult for them to step in for one of the nation's largest bank holding companies in a crisis. Yet they can provide support in ways that would serve to calm customers and markets.

2. Mobile Banking. Smart phones have become today's bank branches. From JP Morgan Chase to community banks, customers have switched their transaction activity to smart phone apps. Unlike Blackberry devices, Apple iPhones are notoriously susceptible to hacking, as celebrities' unhappy experience with nude photos has shown.

Regional and community banks need to acknowledge the obsolescence of their branch networks and repurpose their delivery systems accordingly. That does not mean, however, abandoning retail locations completely. Rather, retail locations need to be reconfigured to occupy smaller spaces and serve different needs, including acting as customer service centers should Internet banking fail due to cyber attacks.

3. Non-Bank Providers. Wall Street is currently bringing to market a significant number of companies that perform banking functions but are not licensed and regulated as such. Multiple self-described "marketplace lenders" including Lending Club (NYSE: LC) debuted in December. The first quarter 2015 deal calendar includes offerings for Square payment service and PayPal's spinoff from eBay.

No uniform set of standards exists to govern these companies' interconnection with the banking system or to assure data integrity and data security. This state of affairs invites calamity, a financial Pearl Harbor as it were. Sorely needed is political collaboration on the scale of WW II war production in order to secure the future of electronic financial commerce.

"Capitalism is messy," opined Felix Rohatyn, a banker whose career repeatedly involved cleaning up large, public messes, including New York City's 1970's insolvency. Internet-based financial services hold great promise and peril alike. Thoughtful planning and disciplined action remain our nation's best bulwark against malevolent behavior of

those who would imperil our financial system and with it our prosperity. The New Year requires new resolve to deal preemptively with the ever growing threat.

[\[i\] The Wall Street Journal](#), Dec. 26, 2014, page 1.