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Consumer Financial Services

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Unlucky Day for Consumer Financial Servicer Providers? The CFPB Issues Its Vendor Management Bulletin on Friday the 13th

By Jonathan D. Jaffe, David A. Tallman

The Bureau of Consumer Financial Protection (the "Bureau" or the "CFPB") may have increased the incidence of triskaidekaphobia among banks and consumer financial service companies when it released Bulletin, 2012-03[i] (the "Bulletin") on Friday, April 13, 2012. In the Bulletin the Bureau announced its intent to exercise supervisory and enforcement authority over how banks and non-bank consumer financial service companies control their third-party vendors (*e.g.*, service providers such as subservicers, foreclosure trustees and law firms, and force place insurers, to name a few).

In the Bulletin, the CFPB announces its "expectations" of the financial institutions over which the Bureau has jurisdiction (which include the nation's largest banks and most non-bank providers of consumer financial products and services). The CFPB is effectively mandating those institutions to:

- Conduct thorough due diligence to verify that the service provider understands and is capable of complying with federal consumer financial law.
- Request and review the service provider's policies, procedures, internal controls, and training materials to ensure that the service provider conducts appropriate training and oversight of employees or agents that have consumer contact or compliance responsibilities.
- Include in contracts with service providers clear expectations about compliance, as well as appropriate and enforceable consequences for violating any compliance-related responsibilities, including unfair, deceptive, and abusive acts and practices.
- Establish internal controls and ongoing monitoring to determine whether the service provider is complying with federal consumer financial law.
- Take prompt action to address fully any problems identified through the monitoring process, including terminating the relationship where appropriate.

Note that the Bulletin applies by its terms only to "federal consumer financial laws," which include (subject to certain limitations) the Consumer Leasing Act, the Electronic Fund Transfer Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, subsections (b) through (f) of section 43 of the Federal Deposit Insurance Act, sections 502 through 509 of the Gramm-Leach-Bliley Act, the Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, the S.A.F.E. Mortgage Licensing Act, the Truth in Lending Act, the Truth in Savings Act, section 626 of the Omnibus Appropriations Act, 2009, and the Interstate Land Sales Full Disclosure Act.

It is also important to note that while the Bulletin focuses on the responsibilities of a financial institution vis-à-vis its service providers, the Dodd-Frank Act gives the CFPB the authority not only to supervise service providers to the same extent as a federal banking regulator may exercise its

supervisory authority over a service provider to a bank,[ii] but also to bring a direct enforcement action against a service provider.[iii] Thus, if a service provider violates a federal consumer financial law because the financial institution failed to exercise adequate oversight over its vendors, the CFPB could exercise its supervisory authority to require the financial institution to improve its vendor management program, bring an enforcement action directly against the service provider, or both. In certain circumstances, it also could bring an enforcement action for the substantive violation against the financial institution itself (*e.g.*, if the Bureau finds that the institution knowingly or recklessly provided substantial assistance to the service provider in connection with a UDAAP violation[iv]).

Most of the obligations described in the Bulletin are consistent with existing regulatory guidance and industry practices to which banks have been subject for years,[v] and more recent requirements.[vi]

The Bulletin is nevertheless noteworthy for at least a few reasons.

First, consumer financial servicer providers that are not affiliated with banks have not been subject to this type of substantive regulation until now. While banks have contractually imposed on their service providers requirements similar to those found in the Bulletin, the Bulletin is the first issuance that directly applies these requirements to non-depository institutions. More importantly, for the first time, those institutions are now potentially subject to regulatory agency action for failing to adhere to those requirements.

Second, the CFPB chose not to follow the Administrative Procedure Act by failing to treat its "expectations" as regulations that are subject to publication, notice and comment. Nor did the CFPB choose to attempt to determine what impact the Bulletin's requirements might have on small businesses, which the CFPB is required to do under the Small Business Regulatory Enforcement Fairness Act ("SBREFA") when implementing regulations. The SBREFA provides that if a proposed rule will have a significant economic impact on a substantial number of small entities, the CFPB must seek input directly from small entities about potential costs of a proposed rule and potentially less-burdensome alternatives before issuing the proposal for public comment. The CFPB has apparently attempted to avoid characterizing the third-party vendor requirements as a regulation by instead calling the document a "Bulletin" and calling the requirements mere "expectations." However, the Bulletin has all the hallmarks of a regulation.

Third, the "expectations" are contained in five short bullet points, providing little of the detail that consumer financial services institutions need for guidance, while at the same time arguably requiring an unprecedented level of due diligence on vendors. For example, as noted above, a covered institution must review its third-party service providers' policies, procedures, internal controls, and training materials to ensure that the service providers conduct appropriate training and oversight of employees or agents that have consumer contact or compliance responsibilities. That is a very broad, open-ended requirement. Contrast that with the OCC's more detailed guidance in OCC Bulletin 2001-47 (Third-Party Relationships)[vii], which provides that banks should thoroughly evaluate the third party's:

- Experience in implementing and supporting the proposed activity, possibly to include requiring a written proposal;
- Audited financial statements of the third party and its significant principals (the analysis should normally be as comprehensive as the bank would undertake if extending credit to the party);
- Business reputation, complaints, and litigation (by checking references, the Better Business Bureau, state attorneys general offices, state consumer affairs offices, and, when appropriate, audit reports and regulatory reports);

- Qualifications, backgrounds, and reputations of company principals, to include criminal background checks, when appropriate;
- Internal controls environment and audit coverage;
- Adequacy of management information systems;
- Business resumption, continuity, recovery, and contingency plans;
- Technology recovery testing efforts;
- Cost of development, implementation, and support;
- Reliance on and success in dealing with subcontractors (the bank may need to consider whether to conduct similar due-diligence activities for material subcontractors); and
- Insurance coverage.

As you can see, most of the OCC's requirements involve safety and soundness concerns, rather than regulatory compliance. Consequently, they will not be particularly helpful to either banks or non-bank consumer financial service companies in interpreting the CFPB's Bulletin.

To demonstrate the significance of this provision, consider a small financial institution that purchases consumer loans and engages a third-party debt collector to collect payments on delinquent obligations. Among other risk controls, the financial institution ordinarily would require the collector to: (a) represent and warrant that it will comply with applicable law and certain performance standards; (b) indemnify the financial institution against losses incurred in connection with a compliance failure; and (c) agree to periodic auditing and reporting requirements. But the financial institution could rely at least to some extent on the service provider's collection expertise – a smaller institution that does not service loans or engage in collection activity should not necessarily be expected to know all of the ins-and-outs of the Fair Debt Collection Practices Act. However, the CFPB now appears to expect such an institution to investigate the debt collector's substantive understanding of the FDCPA and other federal consumer financial protection laws and also to assess the sufficiency of all of the collector's compliance controls.

Unlike the OCC's guidance in OCC Bulletin 2001-47, the CFPB's Bulletin fails to include any limitations based on the level of risk a third-party vendor poses to the financial institution. The OCC recognized that the risk management principles it identified were to be adapted as necessary to reflect specific circumstances and individual risk profiles. As the OCC noted,

> In practice, a bank's risk management system should reflect the complexity of its third-party activities and the overall level of risk involved. Each bank's risk profile is unique and requires a tailored risk mitigation approach appropriate for the scale of its particular third-party relationships, the materiality of the risks present, and the ability of the bank to manage those risks.

While the consent orders entered into by federal banking agencies and the largest residential mortgage loan servicers noted above do not contain a similar limitation, the consent orders were relatively specific in identifying the vendors in question, such as firms providing representation of the servicers in foreclosure and bankruptcy proceedings, which clearly rise to the level of relationships that entail material risk.

Finally, the CFPB recognizes at the outset of the Bulletin that financial institutions often retain service providers precisely because they need to rely on expertise that would not otherwise be available without significant investment. But this acknowledgement seems little more than lip service, because

the Bulletin essentially requires financial institutions to develop substantive expertise with respect to all of the compliance obligations that might apply to any outsourced function.

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[i] http://files.consumerfinance.gov/f/201204_cfpb_bulletin_service-providers.pdf.

[ii] 12 U.S.C. 5515(d).

[iii] 12 U.S.C. 5536.

[iv] 12 U.S.C. 5536(a)(3).

[v] See, for example, OCC Bulletin 2001-47 on Third-Party Relationships at http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html, and the FFIEC Information Technology Handbook at http://ithandbook.ffiec.gov/it-booklets.aspx.

[vi] See, for example, the vendor management requirements articulated in the 2011 residential mortgage servicing consent order entered into between various banking agencies and residential mortgage loan servicers at http://www.occ.gov/news-issuances/news-releases/2011/nr-occ-2011-47.html.

[vii] http://www.occ.gov/news-issuances/bulletins/2001/bulletin-2001-47.html

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K&L Gates' Consumer Financial Services practice provides a comprehensive range of transactional, regulatory compliance, enforcement and litigation services to the lending and settlement service industry. Our focus includes first- and subordinate-lien, open- and closed-end residential mortgage loans, as well as multi-family and commercial mortgage loans. We also advise clients on direct and indirect automobile, and manufactured housing finance relationships. In addition, we handle unsecured consumer and commercial lending. In all areas, our practice includes traditional and e-commerce applications of current law governing the fields of mortgage banking and consumer finance.

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