

EMBRACING Change

— by KIRK STEPHENS —

“Regime change.” “Rewriting the book.” “New World.” Those are only some examples of the sweeping language industry analysts have used to describe the Consumer Financial Protection Bureau’s (CFPB) Mortgage Servicing Rule leading up to its implementation. ¶ Now that the rule implementing provisions under the Real Estate Settlement Procedures Act Regulation X is effective, we’re learning how to navigate in this new regulatory environment. And as it turns out, many of us are realizing that operating under the ambit of CFPB supervision is not the foreign frontier some expected it to be. ¶ While the rules governing mortgage servicing have indeed changed—these demands are not insurmountable.

The new servicing rules from the Consumer Financial Protection Bureau are challenging the industry to actively protect consumers from harm. It requires a different perspective and some targeted solutions.

I've already seen banks and non-banks, lenders and servicing institutions, each with their unique set of challenges, establish the compliance management programs that prepare for CFPB examinations using resourceful, innovative solutions. These creative approaches—often capitalizing on new partnerships or collaborations—can help smaller organizations create the robust compliance management systems (CMS) of larger institutions. But those same larger institutions can also learn how to use their existing capacity in a more strategic, focused and creative way.

The appropriate CMS and its various components differ for large banking organizations and non-bank servicers, and depend on many factors, but the risk focus is the same.

As laid out in the CFPB's Supervision and Examination Manual, "effective systems and controls . . . detect, prevent and correct practices that present a significant risk of . . . causing consumer harm." Today, a financial service provider's impact on a consumer (consumer risk) is a critical and inseparable part of the entire financial ecosystem. Consumer risk touches every element of mortgage servicing, necessitating an organization's risk-mitigation approach that is systemic, responsive and consistent.

The CFPB's supervisory scope and mandate require a comprehensive CMS—for bank, non-bank and vendor alike—that is "integrated into the overall framework for product design, delivery and administration." Not only are compliance and operational risk intrinsically connected, so is the risk exposure and liability of the lender and third parties that influence consumer experience.

This dispersed-risk responsibility is forcing banks and non-banks alike to critically evaluate their operations with fresh and objective eyes. With their findings, they can better innovate and strategically invest in areas such as vendor management, information security and customer service.

Dodd-Frank and the 're'-conception of risk

The Dodd-Frank Wall Street Reform and Consumer Protection Act conceptually shifted how we view the intersection of risk, liability and vendor management as they relate to consumer protection. Lenders, vendors and any actor in the consumer-product supply chain must essentially ensure the same level of compliance as the lender—and conduct the oversight and due diligence that guarantees the compliance of other downstream vendors.

The CFPB's Service Provider Guidance Bulletin 2012-03 from April 13, 2012, clarifies that financial institutions are expected to establish and/or revamp their vendor-management program with their third parties so that it "ensures compliance with federal consumer financial law, which is designed to protect the interests of consumers and avoid consumer harm."

Whereas risk, compliance and responsibility in the past were transferred and managed contractually, the entire chain of custody is now responsible—and liable—for consumer risk

occurring anywhere within the process.

Large financial institutions with limited insight into the customer interactions of suppliers are making significant changes to their compliance management systems. But service providers will, in most cases, be subject to the same level of heightened scrutiny. Both as vendors and responsible parties for downstream vendors, service providers must establish the comprehensive risk-management system and processes that reflect the same mitigating components.

Managing service providers

The CFPB has noted that an effective third-party risk-management program will include the following elements:

- Due diligence—conducting independent review in engaging or maintaining the third-party relationship to ensure that the provider is capable of compliance;
- Review of policies and procedures—obtaining and examining information about the vendor's established policies, internal controls, training and oversight to ensure compliance;
- Establishing expectations with clear consequences—contractually establishing expectations, consequences of not meeting those expectations, and enforcement mechanisms related to compliance;
- Establishing internal controls and monitoring—creating the real-time review and oversight capabilities to identify and correct vendor compliance issues; and
- Remediate problems—acting to address any issues arising in the course of monitoring, including severing contractual relationships.

The processes and strategic investments that integrate these components into a comprehensive CMS naturally differ for each organization. However, the cumulative impact these changes have had on the industry is already becoming apparent.

Lender approaches

Mortgage lenders have had to reassess compliance risk because they have had to redefine the customer. For large institutions, the customer traditionally was the secondary market investor, with the consumer's satisfaction playing a role only to the extent that is required to close the loan.

Now consumer satisfaction is not simply a work input for the customer, but a systemic awareness and capacity to identify problems as they emerge. For example, flawed underwriting and marketing practices must be addressed at the outset and adjusted as regulatory changes or red flags arise. Essentially, the ability to identify dissatisfied customers and actively manage those individual complaints will allow organizations to intervene before the complaint is filed with the CFPB.

Lenders that originated mortgages and then sold them to the secondary market were able to transfer a number of risks, including credit and compliance risk where interfacing with the consumer was no longer the lender's responsibility. Current expectations close the gap and now put "skin in the game," requiring mortgage lenders to exercise fiduciary consumer responsibility when selling mortgages. This, in turn, requires lenders to exercise more due diligence in the sales process—

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thus retaining certain compliance risk and establishing a level of control and authority to mitigate it.

The following areas have proven particularly challenging:

- acquiring the CMS capabilities to incorporate consumer risk;

- developing internal compliance and vendor expertise;
- establishing risk metrics that take into account the vendor's interaction with the consumer;
- limiting and monitoring third-party autonomy across a range of areas; and
- audit-readiness in the forms of checks and balances and response times.

According to a July 2012 survey from Boston-based CFO Research Services, *Working Well Together: Managing Third-party Risk in a More Integrated World, Focus on Banking and Financial Services* (www.cfo.com/research/index.cfm/displayresearch/14651437?topic_id=10240154), the No. 1 concern of financial services executives is improving visibility into the full range of risk exposures with third-party relationships, garnering almost one-third of all responses.

Under increased scrutiny, the capability to monitor and exercise decision-making authority over vendors is essential to compliance.

This present-day concern is warranted, despite the fact that vendor oversight has been a subject of federal regulation following the financial crisis of 2008. The Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC) established the expectation that senior management and boards of directors would assume responsibility for third-party management, but the CFPB bulletin on the issue offered additional guidance on enforcement. Specifically, the regulator broadly defined "service provider," and clarified that the list of measures a bank might take to prevent undue consumer risk is non-exhaustive.

The renewed focus on third-party risk is borne out by recent enforcement actions brought against organizations failing to comply with the mandates.

The federal banking regulators (the CFPB, in coordination with the OCC and FDIC) have ordered several large financial institutions to pay restitution and civil money penalties. Just this year, Bank of America agreed to a \$783 million settlement, including \$45 million in penalties to the CFPB to resolve federal regulators' claims that the bank misled customers and mismanaged oversight of third parties in how it marketed and billed for certain credit card add-on products.

Lenders have made changes, strategic shifts and adjustments to their governance programs in order to facilitate vendor oversight and management. Whether through targeted hiring, technological innovation, audit exercises or re-evaluation of the overall business model, organizations of all sizes are undertaking initiatives to address the third-party exposure that has become a focus of CFPB enforcement.

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Vendor risk diversification

Many larger financial institutions have reassessed their vendor supply chain, identifying high-risk vendors (consumer interfacing), then consolidating or diversifying to reach the appropriate risk tolerance within their organization. This of course includes re-evaluating certain business lines and taking action that could potentially result in eliminating to the greatest extent possible the business lines or units that are the greatest source of consumer risk.

Indeed, non-bank mortgage servicers have been buying mortgage servicing rights from banks at a rapid pace as these banks attempt to minimize organizational risk. Ironically, these transactions are largely facilitated by the robust requirements of the CFPB's recently implemented mortgage servicing rules.

So the sell-off and acquisition of the banks' mortgage servicing business lines is fueling the recent growth of some large mortgage servicers. The rate at which this growth is occurring has been a cause of concern for some regulators, and will have repercussion for lenders selling their portfolios as well as the servicers buying them.

The CFPB's settlement with Atlanta-based Ocwen Financial Corporation sent a clear message that organizations must be prepared—from a CMS expertise, technology and capacity perspective—to absorb and manage the consumer risk associated with new loan acquisitions, according to the Ocwen consent order.

It's likely that lenders on the selling side of servicing transactions will also come under scrutiny for failing to perform the due diligence that ensures consumers will not be harmed upon sale.

Ongoing vendor education, communication and documentation

Establishing the ability to maintain the appropriate records and recall capabilities to demonstrate due diligence has been a natural area of focus for lenders leading up to January. Elements include a readily accessible CMS overview, up-to-date training (internal and vendor) protocols, a consumer complaint monitoring and resolution system, and a comprehensive information security plan.

Some lenders have been particularly innovative and proactive in the area of ongoing vendor education. The CFPB's minimum requirements stipulate that lenders address training in contract terms, standard operating procedure and ongoing communications with key vendors. But lenders themselves are outsourcing this function to vendors that specialize in innovative, expert-driven employee training platforms, making this an area where some in the industry have surpassed regulatory expectation.

Vendor approaches

Federal bank regulators have made clear that, despite the lender's assumption of all consumer risk, vendors are individually responsible for their own risk and that of downstream vendors. Non-bank servicers now covered under Dodd-Frank are dealing with increased scrutiny from the CFPB as well as from lenders.

Essentially, servicers—no matter their size—have been tasked with developing the CMS and third-party management capabilities commensurate to those of banks.

Vendors, which traditionally assumed from lenders the

risk associated with consumer contact, have faced the particular challenge of sharing that risk, establishing a CMS that facilitates communication, transparency, monitoring and automation for the lender. The overarching concern is that the sheer increase of consumer contact further exposes a servicer to the consumer risk those communications aim to minimize.

Relevant CFPB-issued Real Estate Settlement Procedures Act (RESPA) (Regulation X) provisions addressing these requirements include:

- Rule 1024.33 Mortgage Servicing Transfers—requires minimum borrower notifications regarding the sale, transfer, assignment and servicing of the loan.
- Rule 1024.37 Force-Placed Insurance—requires timed and written notifications.
- Rule 1024.39 Early Intervention Requirements—calls for servicers to make a good faith effort to establish live contact with delinquent borrowers.
- Rule 1024.41 Loss-Mitigation Procedures—requires servicers to notify borrowers in the case of missing documents, loan approval and denial. Here, “reasonable diligence” includes forms of contact beyond written communication.

Depending on the size and function of an organization, the capacity may already exist to create this comprehensive vendor-management system internally, or it may necessitate further outsourcing (for technology solutions, for example).

The deficiencies the CFPB sought to eliminate through regulation of non-banks stem from their general lack of CMS structure, with compliance embedded in the business lines rather than throughout the organization. Tracking, monitoring and resolution of consumer complaints did not figure prominently in the compliance approach because consumer satisfaction did not figure prominently in the risk landscape.

Systemic consumer focus

In general, servicers have met the challenge head-on through close collaboration with lender banks and even the CFPB. In fact, prudent vendors seeking to improve customer service and minimize CFPB consumer complaints are learning that monitoring and understanding customer issues internally is essential to avoiding their escalation externally.

The goal of CMS in this instance is to resolve any customer confusion or concern before it is lodged in the CFPB consumer complaint database. By creating a sort of internal database to understand which specific communications or products generate the most incidences, servicers can focus CMS resources in those areas.

Some servicers have gone “above and beyond” regulatory expectations with regards to customer service, deploying robust consumer complaint log and tracking systems to identify, measure and plot trends of dissatisfaction that facilitate the detection of potential consumer failures. This approach is especially prudent and effective in addressing the deceptive, abusive acts underlying the fair lending concerns of lenders.

The emerging risk-management market

Larger servicers tend to outsource certain functions as part of their business models and therefore have benefited from existing vendor-management expertise and an established vendor oversight program. While these servicers have significantly changed their

third-party risk-management systems, the transition has been less about capacity and more about CMS. While approaching CMS from a due-diligence perspective rather than a process-

management focus, servicers with robust vendor-management programs can successfully accommodate consumer risk.

In fact, smaller vendors that have used existing vendor-management expertise and systems to successfully meet the CFPB examination requirements are seeing new opportunities in the industry. The increased regulatory demands and scrutiny have essentially commoditized compliance and centralization. In other words,

an insurance policy is no longer the product valued by lenders—it’s the CMS (and the related transparency, automation and communication functions) and expertise that go along with it.

The vendors that succeed will be those that can establish themselves as ethical business partners.

Where are we going?

As lenders and servicers of all sizes are directly responsible to protect consumers to ensure their ongoing success, opportunities for collaborative, proactive and more positive relationships with all stakeholders abound.

It remains to be seen how smaller banks, faced with challenges of capacity and cost, address consumer compliance. It’s likely that we will see these organizations enter into collaborative, cost-sharing relationships at the community level. For example, smaller community institutions might use a single compliance affiliate (as a holding company would use for all subsidiaries) or share the cost of an outside consultant.

This approach would be practical and economically viable for community banks that are limited to deposit-taking and local lending. However, regulators still hold each individual bank responsible for meeting consumer-protection rules and laws. Larger banks will need enhanced systems and capable partners who can handle volume and complexity from both a technical and expertise standpoint.

From a vendor perspective, it’s likely we will continue to see managing general agents emerge as risk-management specialists to satisfy a new market demand. To that end, compliance-driven practices and audit expertise will be the new currency in which vendors trade.

The vendors that succeed will be those that can establish themselves as ethical business partners, innovating and investing in their technology, clearly possessing compliance expertise, assuming shared risk with sound practices and training, and embracing the consumer as part of the ultimate driver of future success. **MB**

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