# OSC
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# Compliance Quarterly

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## Embracing Change

*by Kirk Stephens*

"Regime change." "Rewriting the book." "New World." Those are only some example 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 the CFPB supervision is not the foreign frontier some expected it to be.

While the rules governing mortgage servicing indeed change—these demands are not insurmountable.

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.

FULL ARTICLE

## Dispelling The Myths About The Effects Of Consolidation On Community Banks

Bank consolidation is a long-term trend that has reshaped the financial industry. Community banks[1] and policymakers have continuously expressed concern about the possible decline of community banks due to consolidation. A study conducted by the Federal Deposit Insurance Corporation (FDIC), however, reveals that the "projected decline of the community banking sector has been significantly overstated."[2] Contrary to the popular view that consolidation will lead to the marginalization of community banks, the FDIC's study shows an increase in the number of community banks, both in asset size and number, since 1985.

Consolidation is not new to the United States banking industry. It has been around since 1980 and will likely continue to be part of the industry far into the future. This long-term trend has affected

[CONTINUED ON PAGE 3]

1. The FDIC study defines community banks as financial institutions providing traditional banking services (i.e. collecting deposits and lending to local businesses) to their local markets with assets between $100 million and $10 billion. 2. Benjamin R. Backup and Richard A. Brown, "Community Banks Remain Resilient Amid Industry Consolidation," *FDIC Quarterly* 8, no. 2 (2014): 33-43.


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***A value-added newsletter for clients and friends of OSC.***

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# Recapping Violations Identified by the CFPB

In its third edition of *Supervisory Highlights* (Report), the Consumer Financial Protection Bureau (CFPB) recaps, in part, its observations relating to violations of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in the markets it oversees, including the mortgage servicing industry. The CFPB explains that it continues to encounter weaknesses in the compliance management systems of many institutions and as a result has directed these institutions to implement new changes to prevent violations.

**I. Identified Violations**

It is important to understand that the issues discussed below involve practices under pre-existing law and not under the new mortgage servicing rules. The new rules took effect January 10, 2014, before the CFPB drafted its Report. In its Report, The CFPB notes that its examiners have found that servicers are engaging in practices that can be harmful to consumers. Common uncovered law violations relate to: (1) servicing transfers, (2) waivers of rights in loss mitigation agreements, (3) payment processing, (4) furnishing information to consumer reporting agencies, and (5) issues relating to the servicing of defaulted loans.

**A. *Mortgage Servicing***

Although the new mortgage servicing rules specifically address servicing transfers, pre-existing law also prohibits servicers, including transfer servicers, from engaging in acts or practices that are unfair, deceptive, or abusive. According to the CFPB, transfer servicers "failed to honor existing permanent or trial loan modifications after a servicing transfer." Servicers either failed to identify a trial loan modification in their records or failed to honor the trial modification unless they were able to independently confirm that the previous servicer properly offered a trial modification. One servicer, for example, tried to collect the contractual monthly payment amount rather than the lower trial modification amount from the borrower. CFPB examiners also found that certain servicers failed to provide consumers notices of newly transferred loans within 15 days of the transfer as required by the Real Estate Settlement Procedures Act (RESPA).

**B. *Waiver of Rights in Loss Mitigation Agreements***

The CFPB uncovered unfair practices relating to the waiver of rights in loss mitigation at two servicers. The unfair practices involved the requirement that in order for borrowers to obtain forbearance or a loan modification each borrower, independent of individual circumstance, must enter into an all-encompassing waiver of existing claims. The CFPB notes that the aforementioned broad waiver clauses presented by the servicers to the borrowers involved unfair practices because these were styled in a broad "take it or leave it" form without taking into account the individual's circumstance and their potential claims.

**C. *Payment Processing***

The CFPB uncovered deceptive practices by servicers in several areas. First, CFPB examiners identified deceptive marketing for biweekly payment programs to borrowers. The Report explains that "the overall net impression of the solicitation was that, if a consumer signed up for the program, the servicer would be crediting payments biweekly, when in fact the program submitted payments monthly as usual and retained the extra money to make a 13th annual payment." The deceptive marketing led consumers to believe that signing up for the biweekly program would result in saving mortgage interest because of the biweekly crediting. Communications with consumers failed to make it clear that the 13th payment was the only source of saving under the biweekly program.

Secondly, the CFPB found deceptive practices when sending annual notices to borrowers regarding the escrow account balances at one servicer. The escrow statements to delinquent borrowers, for example, misinformed the consumer. The statements notified the consumer that he/she would receive a refund of escrow surplus, when the account was in fact delinquent and the consumer was not going to receive a refund.

Thirdly, the CFPB uncovered violations of the Homeowners Protection Act (HPA). The Report states that "violations included failure to automatically terminate private mortgage insurance (PMI) on the date that the principal balance reaches 78 percent of the original value of the property." To illustrate, the CFPB found a servicer to be in violation of the HPA because it imposed an additional requirement not found in the HPA. The servicer demanded that the loan have an origination date of at least 2 years before terminating the PMI. Examiners also found that some servicers failed to return premium amounts to the borrower within the 45 days required under HPA after the borrower properly requested PMI cancellation.

**D. *Furnishing of Information to Consumer Reporting Agencies***

The CFPB discovered violations of the Fair Credit Reporting Act (FCRA) resulting from a servicer's failure to comply with the Furnisher Rule (Rule). The Furnisher Rule applies to entities responsible for providing information to consumer reporting agencies and imposes specific obligations. One servicer engaged in a substantial amount of short sales. The servicer, however, used the credit reporting code for foreclosure when reporting the short sales. The failure to properly report the short sale harms the consumer because common underwriting standards treat short sales and foreclosures very differently. To illustrate, a person may be unable to obtain conventional home financing if the short sale is identified incorrectly.

[CONTINUED ON PAGE 4]

[COMMUNITY BANKS, CONT FROM PG 1]

financial institutions in the industry in different ways. First, consolidation has led to a significant decrease in the number of financial institutions with assets less than $100 million. This is evidenced by the fact that the total number of institutions with less than $100 million in assets fell by 85 percent between 1985 and 2013. Secondly, consolidation has substantially increased the share of assets and size controlled by the largest institutions. The FDIC study notes that, "[i]n all, the total assets of institutions with assets greater than $10 billion grew from $1.1 trillion (28 percent of industry assets) in 1985 to $11.9 trillion (81 percent of industry assets) in 2013 … ."

Financial institutions with assets between $100 million and $10 billion, however, have remained relatively stable amid industry consolidation. The stability of institutions fitting this asset category is important because a majority of community banks are found in this size group. The study shows a growth in the number of community banks and their assets. Between 1985 and 2013, for example, the number of banks with assets between $100 million and $1 billion grew by 7 percent, while banks with assets ranging from $1 billion to $10 billion grew by 5 percent. Moreover, banks between $100 million and $1 billion experienced a 27 percent increase in assets between 1985 and 2013. Banks with assets between $1 billion and $10 billion experienced a 4 percent increase. The FDIC study further notes that "the most obvious indicator of the resilience of community banks in the face of industry consolidation is the fact that 93 percent of FDIC-insured banking charters met the community banking definition at year-end 2013, up from 87 percent at the end of 1985."

After more than 30 years of consolidation, community banks have remained resilient with more than 90 percent of banking charters at the end of 2013 meeting the FDIC's community bank definition. The FDCI study concludes that long-term consolidation has not led to a decline in the number of community banks as believed by many. Rather, the study emphasizes that community banks are expected to remain relatively unaffected by long-term consolidation.

FLOOD INSURANCE INFO

# Definitions of FEMA Flood Zone Designations

**Zones indicating mandatory purchase of flood insurance in participating communities**

| ZONE | DESCRIPTION |
|---|---|
| A | Areas subject to a one percent or greater annual chance of flooding in any given year. Because detailed hydraulic analyses have not been performed on these areas, no base flood elevations are shown. |
| AE, A1-A30 | Areas subject to a once percent or greater annual chance of flooding in any given year. Base flood elevations are shown as derived from detailed hydraulic analyses (Zone AE is used on new and revised maps in place of Zones A1-A30). |
| AH | Areas subject to a one percent or greater annual chance of shallow flooding in any given year. Flooding is usually in the form of ponding with average depths between one and three feet. Base flood elevations are shown as derived from detailed hydraulic analyses. |
| AO | Areas subject to one percent or greater annual chance of shallow flooding in any given year. Flooding is usually in the form of sheet flow with average depths between one and three feet. Average flood depths are shown as derived from detailed hydraulic analyses. |
| AR | Areas subject to a one percent or greater annual chance of flooding in any given year due to a temporary increase in flood hazard from a flood control system that provides less than its previous level of protection. |
| A99 | Areas subject to a one percent or greater annual chance of flooding in any given year, but will ultimately be protected by a flood protection system under construction. No base flood elevations or flood depths are shown. |
| V | Areas along coasts subject to a one percent or greater annual chance of flooding in any given year that also have additional hazards associated with velocity wave action. Because detailed hydraulic analyses have not been performed on these areas, no base flood elevations are shown. |
| VE, V1-V30 | Areas along coasts subject to a one percent or greater annual chance of flooding in any given year that include additional hazards associated with velocity wave action. Base flood elevations are shown as derived from detailed hydraulic analyses. (Zone VE is used on new and revised maps in place of Zones V1-V30). |
| **Zones indicating non-mandatory (but available) purchase of flood insurance in participating communities.** | |
| D | Areas of undetermined flood hazard where flooding is possible. |
| X, C | Areas of minimal flood hazard from the principal source of flood in the area and determined to be outside the 0.2 percent annual chance floodplain. (Zone X is used on new revised maps in place of Zone C.) |
| X (Shaded), X500, B | Areas of moderate flood hazard from the principal source of flood in the area, determined to be within the limits of one percent and 0.2 percent annual chance flood plain. (Shaded Zone X is used on new and revised maps in place of Zone B.) |
| XFUT | For communities which elect to incorporate future floodplain conditions into their FIRMs, the future flood zone shown on the new map indicates the areas which the community believes will become the one percent annual chance floodplain (or the future Special Flood Hazard Area), due to projected urban development and land use. |
| None | Areas of undetermined flood hazard that do not appear on a Flood Insurance Rate Map or Flood Hazard Boundary Map, where flooding is possible. |

# Banks Earn $37.2 Billion in First Quarter 2014

FDIC-insured banks and savings institutions earned $37.2 billion in the first quarter; $3.1 billion lower than the industry earned a year ago. The average return on assets – a standard measure of bank profitability – fell to 1.01 percent from 1.12 percent reported a year ago. According to the FDIC, the decline in earnings was mainly attributed to a $7.1 billion decline in noninterest income—mainly from reduced mortgage activity and a drop in trading revenue. Despite earnings decline, more than half of the 6,730 insured institutions reported year-over-year growth in quarterly earnings.

"Asset quality continues to improve, loan balances are trending up, fewer institutions are unprofitable, and the number of problem banks continues to decline. However, industry revenue has been affected by narrow margins, modest loan growth, and declines in noninterest income as higher interest rates have reduced mortgage-related activity and trading income fell, said FDIC Chairman Martin J. Gruenberg."

The number of problem institutions declined for the 12th consecutive quarter from 467 to 411. Five FDIC-insured institutions failed in the first quarter.

[CFPB VIOLATIONS, CONT FROM PG 2]

CFPB examiners also found misreporting to consumer reporting agencies at a different servicer. The servicer failed to properly report borrowers who had trial loan modification. Instead, the servicer reported the borrowers as being in the foreclosure process. The servicer also failed to properly report whether the loan modifications were made under governmental or proprietary programs.

**E. Other Default Servicing Issues**

The CFPB discovered a servicer's program improperly charging borrowers identified loss mitigation costs. Examiners also noted two servicers at risk of violating the law and creating consumer harm by failing to apply applicable checks when dealing with a borrower with a military status before referring the borrower to foreclosure. Moreover, the CFBP identified an unfair act relating to a military borrower who was granted a deferred payment plan pursuant to state law while on active duty. The servicer failed to properly code the account to show the deferral. Consequently, the borrower was sent collection letters and received collection calls stating that the account was past due. The servicer failed to correct the mistake even after the borrower complained. In addition, the servicer charged the borrower late fees and reported the loan to the credit bureaus as delinquent.

**II. Conclusion**

The Report published by the CFPB is intended to provide general information about its supervisory program and to help communicate the standards of conduct the CFPB expects from the entities it supervises. While speaking at the Mortgage Bankers Association's National Mortgage Servicing Conference this year, Deputy Director of the CFPB Steven Antonakes clearly laid out the CFPB's expectations. He explained that "in these very early days, technical issues should simply be identified and corrected." The CFPB expects servicers to "assess loss mitigation applications with care[,] … pay exceptionally close attention to transfers[,]" and use lender-placed insurance as a last resort rather than as a "profit center." Although the CFBP is not looking for perfect compliance with the new rules, Antonakes' remarks indicate that the CFPB will be taking a narrow view of what constitutes a "good faith effort" to comply. He indicated, for instance, that a "good faith effort does not mean servicers have the freedom to harm consumers."

# NEWS BRIEFS

## Bill Introduced to Revise Regulatory Threshold

Senators Pat Toomey (R-PA) and Joe Donnelly (D-IN) introduced the Consumer Financial Protection Bureau Examination and Reporting Threshold Act of 2014. The purpose of the bill is to increase "the threshold figure at which regulated depository institutions are subject to direct examination and reporting requirements of the CFPB. The threshold would be raised from existing $10 billion to $50 billion.

## CFPB Releases Overdraft Program Data

The CFPB moved closer to likely rulemaking on overdraft programs with the release of a new report entitled "Data Point: Checking account overdraft." The report is based on account-level and transaction-level data for about two million accounts at large banks covered by the CFPB's supervisory authority. The CFPB has raised questions about the ability of consumers to anticipate and avoid overdraft costs.

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## OCC Issues Bulletin on Consumer Debt Sales

The Office of the Comptroller of the Currency issued Bulletin 2014-37 on Consumer Debt Sales. The Bulletin addresses the application of consumer protection requirements and safe and sound banking practices to debt sales by OCC-supervised institutions (national banks and federal thrifts) of all sizes, including community banks. After summarizing the operational, reputation, compliance, and strategic risks associated with consumer debt sales by financial institutions, the Bulletin discusses the OCC's supervisory concerns from both safety and soundness and consumer protection point of view including selling debt without knowing buyer's collections practices; providing customer information without appropriate customer disclosure or privacy laws; transferring inadequate customer account information to buyer; and failing to institute appropriate internal oversight of debt sale arrangements.

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## Fannie Mae Enforces New Force-placed Insurance Rules June 1

As of June 1, Fannie Mae requires servicers to change how they work with lender-placed insurance carriers by restricting servicers from having financial interests in force-placed insurers with which they do business. The new rules also prevent lender-placed insurers from passing on to borrowers the cost of any commissions the servicers earn for putting this coverage on a property. Servicers are required to file annual certifications attesting to compliance.

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## Hensarling Questions Reputational Risk Ratings

House Financial Services Committee Chairman Jeb Hensarling (R-Texas) challenged the prudential banking regulators' use of reputational risk in CAMELS ratings, suggesting that examiners are using "subjective judgments." He expressed particular concern that regulators might use a reputational risk rating to pressure banks to sever relationships with law-abiding customers in industries that government official disapprove of or that receive negative press coverage.

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## ABA Seeks CFPB Clarification of Mortgage Servicing Rules

The ABA sent a letter to the CFPB requesting several clarifications to the mortgage servicing rules. The ABA asks the CFPB to make the clarifications part of "regulatory guidance (or regulatory amendment where necessary) that is readily accessible to all servicers, their vendors and advisors, as well as examiners from other regulatory agencies that will examine banks for compliance with CFPB rules. ABA asks for clarification and certainty around several issues: 1) the application of the 120-day rule that prohibits a servicer from sending first filing for foreclosure unless a borrower's mortgage loan is more than 120 days delinquent; 2) reiterates its view that servicers should not be required to provide period statements for charged-off loans; 3) urges the CFPB to finalize as published its interim final rule providing limited exemptions from the servicing rules in situations where the borrower has filed for bankruptcy.

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## Federal Banking Regulators Finalize Joint Guidance on Income Tax Allocation Agreements

Federal banking regulators issued final guidance on income tax allocation agreements involving holding companies and insured depository institutions. The guidance supplements the policy statement by instructing insured depository institutions and their holding companies to review their tax allocation agreements to ensure the agreement expressly acknowledges that the holding company receives any tax refunds as agent. In addition, all banking organizations are asked to insert specific language in their tax allocation agreements to further clarify tax refund ownership. Guidance was issued in response to disputes between holding companies in bankruptcy and failed institutions regarding ownership of tax refunds. Regulators have asked institutions and holding companies to implement the guidance as soon as reasonably possible but no later than October 1, 2014.

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## Federal Banking Agencies Decline ABA Request for Flood Insurance Guidance

Federal Banking Agencies have declined to provide requested guidance to facilitate compliance with the 2012 Biggert-Waters flood insurance reform law and this year's Homeowner Flood Insurance Affordability Act, which addressed affordability of flood insurance in Biggert-Waters. ABA had written the agencies asking for a timeline and implementation plans for flood insurance changes. ABA also requested Agencies to work with FEMA to update and maintain Mandatory Purchase of Flood Insurance Guidelines, a publication that is widely relied on by the industry. The Interagency letter acknowledged "the importance of information and guidance to institutions in light of the various statutory changes," but disavowed responsibility for updating the guidance because "much of the information contained in the Guidelines pertained to flood insurance matters outside the Agencies' authority." The Agencies confirmed that "provisions pertaining to detached structures [HFIAA 13] became effective upon enactment." HFIAA 13 permits a bank to exercise its discretion not to require a flood policy covering detached, non-residential structures.

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