The New Non-Bank

It's a whole new world for non-bank lenders when it comes to compliance. The Consumer Financial Protection Bureau has rewritten the rulebook.

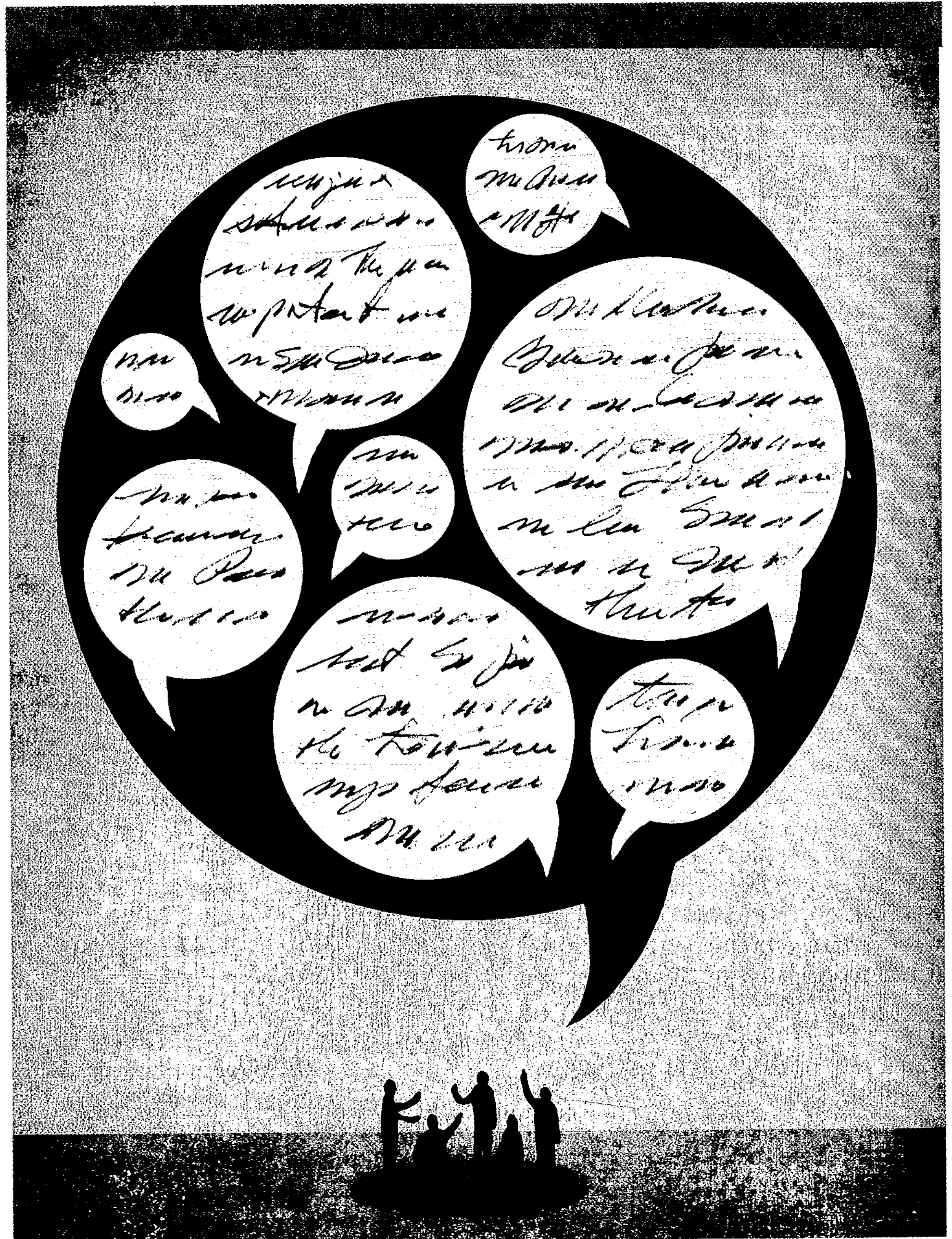


ILLUSTRATION BY KEN ORVIDAS

Compliance Manual

Non-bank mortgage lenders are in the midst of the biggest transformation of the mortgage industry in history. Trying to get a handle on what that means for individual companies is critical. Yet it will take some effort, as the layers of new compliance requirements are thick. The most significant development coming out of the financial crisis for non-bank lenders was the creation of the first new federal regulatory agency in a decade—the Consumer Financial Protection Bureau (CFPB). The CFPB, which just celebrated its one-year anniversary, consolidates most consumer financial protection authority under its jurisdiction—particularly protections impacting mortgage-related activities: the Real Estate Settlement Procedures Act (RESPA), Equal Credit Opportunity Act (ECOA), Truth in Lending Act (TILA), Home Mortgage Disclosure Act (HMDA), Fair Credit Reporting Act (FCRA), Home Ownership and Equity Protection Act (HOEPA) and the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act). The Dodd-Frank Wall Street Reform and Consumer Protection Act also gave the CFPB rule-making and enforcement authority to prevent unfair, deceptive or abusive acts and practices (UDAAP) in connection with any transaction with a consumer for a financial product or service, or the offering of a consumer financial product or service. With this new authority, Dodd-Frank added "abusive" acts to the CFPB's jurisdiction, making compliance risks for

Changes under the new law will require non-bank lenders to make significant enhancements to their current compliance programs.

regulated entities more difficult to assess than under the Federal Trade Commission's (FTC's) authority.

UDAAP is just one sign of the radical change in store for mortgage companies when it comes to the compliance mandate. Non-bank lenders will be newly regulated but also regulated under a completely different regime from that used by other regulatory agencies due to the CFPB's desire to adopt a new approach.

Some in the mortgage industry will be better prepared than others for this demanding new compliance environment. By virtue of the banking industry's long history with regulatory oversight, bank-based lenders are better positioned than their non-bank counterparts to cope with changes in the regulatory environment under Dodd-Frank.

A full engine overhaul vs. a tune-up

Changes under the new law will require non-bank lenders to make significant enhancements to their current compliance programs. Although the CFPB has very publicly announced that it intends to differentiate itself from other regulators, the basic tenets of regulatory compliance will remain unchanged.

To avoid CFPB criticism, non-bank lenders need to act swiftly to bolster their existing compliance programs—but they should be thoughtful and precise in taking action.

At first blush, it may seem reasonable for non-bank lenders to implement a bank-like compliance program. From a practical point of view, however, this approach is akin to believing you need a full engine overhaul when all that may be needed is a tune-up.

Early on, the CFPB made clear its intention to take assertive action against institutions that do not comply with its rules, and the agency has kept its word. In mid-July of this year, the CFPB invoked its first civil enforcement action against a bank for noncompliance with Dodd-Frank regulations. While the bulk of the fine was focused on credit-card-related products, the CFPB's action shows that it takes its legislatively mandated role of protecting consumers seriously.

The CFPB's authority over non-bank lenders in areas such as supervision, investigations and enforcement, coupled with existing state regulatory authority, will likely prove difficult for all companies to manage, though the specific impact may differ in part due to bank size or complexity.

While all institutions, including non-bank lenders, may be concerned about profits and asset quality, one of the most effective investments they can make in today's regulatory environment is in compliance.

At a very high level, non-bank lenders need to institute a culture of compliance from the top down with a focus on transitioning their organization's compliance infrastructure from reactive to proactive.

Because most mortgage companies already have some form of compliance in place, fine-tuning a few fundamental components of a compliance program will get your organization much closer to meeting regulatory expectations. We recommend a tune-up to your regulatory compliance regime in the following five critical areas.

1. Complaints-management programs

Consumer complaints are a particular focus of the CFPB, as evidenced by its borrower-friendly online complaint-intake system. Indeed, complaints about lenders (including non-banks) have long been prime sources of information for regulators when it comes to products and services with potentially unfair, deceptive, abusive or even illegal practices.

The CFPB's consumer complaint center (essentially a database of customer complaints) was launched in July 2011 and began accepting complaints regarding mortgages on Dec. 1, 2011 (see www.consumerfinance.gov/complaint).

The CFPB prioritizes complaints by timeliness of the institution's response to the consumer and the substance of the response itself. An important feature of this complaint center is that it will be a public database. The public complaint database is currently limited to credit-card complaints, but the CFPB has indicated other categories of complaints, including mortgage complaints, will be publicly available.

The public nature of this database represents a sea change in the level of transparency between a financial regulatory agency and its primary clients—consumers. But it also provides an opportunity for non-bank lenders to see themselves from their consumers' point of view.

Financial institutions must respond to complaints received by the CFPB within 15 days and resolve them within 60 days. In addition, provisions in Dodd-Frank have shrunk the timetable for acknowledgment of qualified written responses (QWR).

Under previous RESPA provisions, a servicer had 20 days (excluding legal public holidays, Saturdays and Sundays) to acknowledge a QWR. Dodd-Frank has shortened this to five days, with the QWR response deadline cut from 60 days to 30 (although this may be extended another 15 days as long as the borrower is notified and provided a reason for the delay).

An effective consumer complaints-management program can be leveraged as a first line of defense.

Traditionally, non-banks primarily tracked complaints pertaining to matters that extended beyond day-to-day customer service issues and complaints received by executives, regulators or those that received attention by the media (i.e., escalated complaints).

Today's condensed timelines for responding to consumer complaints suggest the need for lenders to implement a complaints-management system that goes beyond tracking escalated complaints and that provides actionable feedback.

The resulting benefit to non-bank lenders would not just be reflected in the company's compliance record. Complaints offer a method of assessing how well the company is doing with its customers; thus, aggregating information from those complaints can help non-banks maintain and even enhance customer relationships.

Non-banks that use their complaints to identify the root cause of compliance issues and quickly resolve them have an opportunity to use their responsiveness and improved culture of compliance to enhance their brand, which then can help build a stronger customer base in a competitive market.

In order to meet the mandates promulgated by CFPB, a complaints-management program should minimally include: 1) mechanisms to track individual complaints throughout the resolution cycle; 2) trend analysis that identifies potential organizational and/or systemic weaknesses; and 3) powerful reporting capabilities that highlight, to each part of the organization, the information that is most crucial.

According to the CFPB's semi-annual report released in July 2012, mortgage complaints accounted for 43 percent of the approximately 55,300 complaints received from July 2011 to June 2012 (see Figure 1).

The majority of the mortgage complaints (54 percent) related to a borrower's problems when unable to pay, such as issues related to loan modifications, collection or foreclosure (see Figure 2).

So, in addition to a focus on UDAAP, we suggest non-banks focus on their loss-mitigation programs and procedures to ensure communications to borrowers are clear and carefully documented.

An effective consumer complaints-management program can be leveraged as a first line of defense. Note that entities regulated by the CFPB can access the bureau's own online complaint portal and integrate that information with the firm's existing internal complaints-management system.

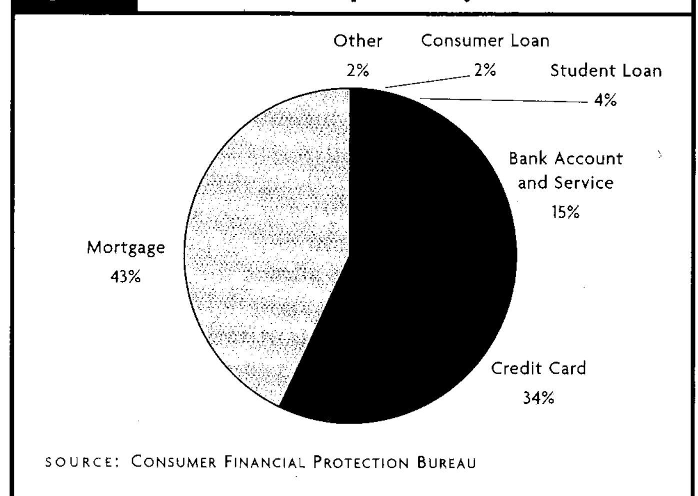
Non-bank lenders should take the opportunity to evaluate their complaints-management program holistically and leverage the tools provided by the CFPB's complaint portal so that complaints become less frequent, responses are improved and the entire organization benefits from the information.

2. Involvement of senior management and reporting

To succeed in the current regulatory environment, senior management should be actively engaged in an institution's compliance effort. This begins with utilizing a more strategic, proactive compliance model.

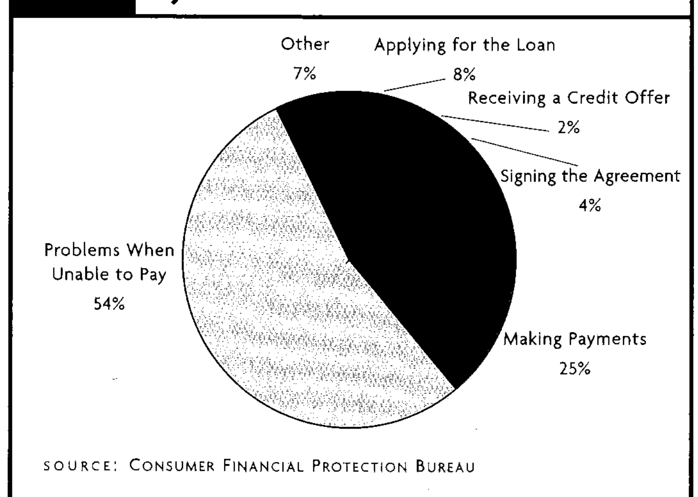
In a proactive compliance environment, business lines and compliance complement one another, and

Figure **1** **Consumer Complaints By Product**



SOURCE: CONSUMER FINANCIAL PROTECTION BUREAU

Figure **2** **Types of Mortgage Complaints Reported By Consumers**



SOURCE: CONSUMER FINANCIAL PROTECTION BUREAU

Non-bank lenders should be aware that third-party and vendor management are drawing considerable regulatory attention.

senior management encourages a strong reporting culture. Information about the state of compliance at the organization flows up to senior management while responsibility and accountability flows from the top down. In a proactive organization, a chief compliance officer (CCO) may perform regular self-assessments, perhaps evaluating fairness to consumers and UDAAP compliance, and develop a plan for remediating compliance errors. Senior management in such an organization would support the CCO's efforts to seek out areas where compliance can be improved ahead of a regulatory exam.

Going one step further, investments in technology and the use of metrics are two ways to enhance the quality of compliance reporting and the exchange of information between compliance and senior management. One technology option is an enterprise content management tool (ECM). ECMs provide a way for organizations to automate a variety of functions, including storage, security and internal reporting capability.

Non-banks may consider redesigning their reporting structure, which is a relatively easy fix, and requires little additional financial investment. A proactive versus reactive compliance program allows for not only more effective senior management oversight because they have higher qualitative and quantitative information, but also allows non-bank lenders to ensure that direct and indirect reporting lines serve this purpose.

3. Exam preparation and management

The CFPB is developing methods to assess risks to consumers from non-bank lenders to ensure that non-bank lenders comply with all of the existing and new federal consumer financial laws. This includes conducting individual examinations as well as requiring specific reports from those entities to determine which of their business lines may warrant a second look.

The bureau has decided to use the same examiners and the same examination procedures to evaluate both banks and non-banks. It will also coordinate its examination efforts with those of the various state regulatory agencies.

Non-bank lenders often express concern about their lack of preparation for multistate examinations. For the well-prepared lender, an examination can be an opportunity to demonstrate compliance and improve the institution's relationships with its regulators. On the other hand, failure to adequately prepare for examinations exposes an institution to an increased regulatory risk.

The newest trend in regulatory examinations being led by the CFPB is for examiners to engage enforcement attorneys in the examination process. This was a highly controversial move, and one that might be re-examined, but even this suggestion is an indication of the pro-enforcement mentality.

Considering the CFPB's utilization of its new examiner/enforcement exam teams, exam preparation is more important than ever. There are some tools non-bank lenders can utilize to be better prepared for such examinations.

Among them are the CFPB's own supervisory field manual (see www.consumerfinance.gov/guidance/supervision/manual). Some areas bureau examiners are likely to look at are compliance with laws impacting financial products across the entire life cycle of those products. The bureau also indicates that examiners will be looking at the lender's internal ability to detect, prevent, and remedy violations that may harm consumers.

Given the negative business and reputational implications of an enforcement action, it is imperative that non-bank officers and employees attending to the exam understand how to manage this process. A relatively small investment in self-assessment, a mock exam or additional training can yield high compliance returns.

4. Corporate governance and policies and procedures

Strong corporate governance is the hallmark of a robust compliance program. Its purpose is to optimize resources to promote accountability and efficiency within the corporate structure. As such, thorough, executable, well-tailored policies and procedures are the strategic link between a company's mission and its daily operations. Perfected policies and procedures are another key component of a compliance program that will serve as a first line of defense against regulatory action.

Financial services companies often make the mistake of confusing the purpose of a policy versus a procedure.

Policies are high-level and general in nature, and should identify company rules, why they exist, when the rule applies, who they cover, how the rule is enforced and the consequences of noncompliance.

Alternatively, procedures should identify specific actions and daily activities as well as explain when to take action, provide examples, demonstrate the steps to follow to complete the objective and describe ways to deal with specific problems.

Alongside increasing UDAAP examinations and

One of the biggest returns from investing in compliance-aiding mechanisms is public good will.

enforcement activity, individual UDAAP programs and policies are becoming more and more popular as a supplement to existing compliance-management programs. All financial institutions—formerly and newly regulated—should take time to understand the risk implications of the new abusive standard. This includes planning for the role that internal auditing will assume in identifying and reporting on UDAAP risks, establishing audit procedures related to product terms and servicing, marketing and advertising, vendor management and overall UDAAP compliance risk management. Strict legal compliance is no longer sufficient to protect your company from UDAAP liability.

The CFPB's UDAAP Examination Procedures state the first examination objective is to "assess the quality of the regulated entity's compliance risk-management systems, including internal controls and policies and procedures, for avoiding unfair, deceptive or abusive acts or practices." This is clear evidence of the importance of corporate governance documentation to the regulators.

5. Third-party/vendor management

Non-bank lenders should be aware that third-party and vendor management are drawing considerable regulatory attention. For smaller companies particularly, the outsourcing of certain functions is necessary to manage costs and resources. Outsourcing is not a problem, so long as non-banks recognize the importance of conducting sufficient front-end due diligence and carefully reviewing service-level agreements.

The CFPB has enforcement authority over regulations affecting non-bank lenders as well as supervision over third-party service providers employed by non-bank lenders. The bureau's April 13, 2012, bulletin says it expects "supervised banks and non-banks to have an effective process for managing the risks of service provider relationships."

In an April 2012 press release, CFPB Director Richard Cordray stated, "Consumers are at a real disadvantage because they do not get to choose the service provider they deal with—the financial institution does. . . . Consumers must not be hurt by unfair, deceptive or abusive practices [UDAAP] by service providers. Banks and non-banks must manage these relationships carefully, and can be held accountable if [those service providers] break the law."

Consequently, regulators will be looking for indications of strong vendor control, including regular on-site visits, monitoring of the vendor's financial health and other provider relationships, and periodic performance audits. Internal and external risk assessments also provide an effective tool for identifying opportunities to improve existing controls and best practices. These assessments demonstrate to regulators a commitment to regulatory compliance.

How can this be accomplished? First, non-bank lenders should focus on critical vendor relationships—those that are essential to their business and perform a service that is deemed crucial to the operation of the institution, such as transaction processing, information technology (IT) providers and vendors that are affiliates or subsidiaries of the company.

One way of doing such an assessment is setting up a rating system—list third-party relationships and what category of service they provide, and rank their importance to the operation. Then set up specific programs to monitor each of those categories and measure how well the vendors perform those functions.

One of the biggest returns from investing in compliance-aiding mechanisms is public good will. The reputation of the lending industry (both banks and non-banks) has been severely damaged as a result of the financial crisis and housing meltdown, particularly in the wake of the mortgage lending irregularities occurring within some of the largest financial institutions. So, in addition to being compliant with regulations, non-bank lenders can also build a public record of compliance and behavior that reflects their focus on providing excellent consumer service. From a public relations perspective, this is a win-win.

Yes, the provisions in Dodd-Frank will add to the regulatory burden of most financial entities, and non-banks do face a special challenge given the long-time absence of federal regulatory oversight on that side of the industry. But despite these challenges, non-banks can meet the new compliance requirements.

Investment in the use of online complaint databases, more effective reporting structures, exam preparation and management, strong corporate governance, better oversight of third-party partners and attention to UDAAP will benefit not just non-bank lenders but also their customers. **MB**

Anastasia Davis is a director for Washington, D.C.–based Treliant Risk Advisors, advising banks, mortgage companies and capital markets clients on regulatory and compliance issues. J. Paul Marker is a director of Risk Management & Strategic Advisory for Treliant Risk Advisors, advising banks and mortgage companies, focusing on mortgage servicing issues. They can be reached at adavis@treliant.com and pmarker@treliant.com.