AMERICAN CONFERENCE INSTITUTE

The Latest on Third-Party Risk Management and Vendor Oversight:

Heightened Regulatory Expectations

Third Party Risk and Compliance

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Managing Third Party Risk and Compliance

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Managing Third-Party Risk and Compliance

Managing Third-Party Risk and Compliance

Why Choose a "Vendor" (Third-Party Service Provider)?

- Special Expertise
- In-house resource constraints
- Cost of delivery
- Scalability
- Development of new products or services
- Marketing connections

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Managing Third-Party Risk and Compliance

Use of Third-Party Service Providers Presents Risks:

- Compliance Risk – from violations of applicable law
- Reputation Risk – from negative public perception
- Strategic Risk – from bad business decisions, including entering into a relationship w/o sufficiently knowing vendor
- Transaction Risk – from vendor's bad service or delivery
- Credit Risk – from vendor's breach of contract w/ company
- Operational Risk -- from inadequate or failed internal processes, systems, or people, or from external events
- Vendor Concentration Risk – too much reliance on one vendor

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CFPB's "Expectations" of Supervised Entities:

"[T]he mere fact that a supervised bank or nonbank enters into a business relationship with a service provider does not absolve the supervised bank or nonbank of responsibility for complying with Federal consumer financial law **to avoid consumer harm**. A service provider that is *unfamiliar with the legal requirements* applicable to the products or services being offered, or that *does not make efforts to implement* those requirements *carefully* and *effectively*, or that *exhibits* weak internal controls, can harm consumers and create potential liabilities for both the service provider and the entity with which it has a business relationship…." (Emphasis added.)

---April 13, 2012 "Bulletin" from Consumer Financial Protection Bureau ("CFPB") on "Third Party Service Providers"

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"The Consumer Financial Protection Bureau ('CFPB') *expects* supervised banks and nonbanks to *oversee* their *business relationships* with *service providers* in a manner that *ensures compliance* with *Federal consumer financial law*, which is designed to *protect the interests* of consumers and *avoid consumer harm*. The CFPB's exercise of its *supervisory* and *enforcement* authority will closely reflect this orientation and emphasis." (Emphasis added.)

---April 13, 2012 "Bulletin" from Consumer Financial Protection Bureau ("CFPB") on "Third Party Service Providers"

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“Supervised Banks and Nonbanks”_

- “Large insured depository institutions, large insured credit unions, and their affiliates (12 U.S.C. § 5515)”
- “Certain non-depository consumer financial services companies (12 U.S.C. § 5514)”

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"Expectations"

- CFPB chose not to follow Administrative Procedure Act by failing to treat its "expectations" as regulations that are subject to publication, notice, and comment
- No apparent attempt to determine impact of Bulletin's requirements on small businesses (which CFPB is required to do under the Small Business Regulatory Enforcement Fairness Act ("SBREFA")
  - If proposed rule will have a significant economic impact on substantial number of small entities, CFPB must seek input directly from small entities re potential costs and less burdensome alternatives before issuing proposal for public comment
- Apparent "end run" around Administrative Procedure Act by calling requirements mere "expectations" rather than a regulation subject to normal procedures for approval; but appear to have same effect as reg.

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Lots of Questions!

Dodd-Frank:

(a) It shall be unlawful for…(1) any covered person or service provider—

(A) to offer or provide to a consumer any financial product or service not in conformity with Federal consumer financial law, or otherwise commit any act or omission in violation of a Federal consumer financial law; or

(B) to engage in any unfair, deceptive, or abusive act or practice; (emphasis added)

12 USCA § 5536(a)(1)

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Dodd-Frank: "Aiding and abetting"…

(a) It shall be unlawful for—

…(3) any person to knowingly or recklessly provide substantial assistance to a covered person or service provider in violation of the provisions of section 5531 of this title, or any rule or order issued thereunder, and notwithstanding any provision of this title, [1] the provider of such substantial assistance shall be deemed to be in violation of that section to the same extent as the person to whom such assistance is provided. (Emphasis added.)

12 USCA § 5536(a)(3)

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“Covered Person” under Dodd-Frank

- Any person that engages in offering or providing a consumer financial product or service; and
- Any affiliate of a person described above if such affiliate acts as a service provider to such person (Emphasis added.)

(12 U.S.C. § 5514(6))

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"Service Provider"

- Generally defined in 1002(26) of the Dodd-Frank Act as "any person that provides a *material service* to a covered person *in connection with* the offering or provision by such covered person of a consumer financial product or service, *including* a person that---
  - Participates in *designing*, *operating*, or *maintaining* the consumer financial product or service; or
  - Processes transactions *relating to* the consumer financial product or service (other than unknowingly or incidentally transmitting or processing financial data in a manner that such data is undifferentiated from other types of data of the same form as the person transmits or processes).
- Does not include a person offering or providing a support service "of a type provided to businesses generally or similar ministerial service"

(12 U.S.C. § 5481(26)(A)&(B).) (Emphasis added)

- May or may not be affiliated with person to which it provides services.

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"Service Provider"

- Marketing companies
- Credit reporting services
- Technology providers
- Doc-Prep Firms
- Escrow
- Sub-servicers
- Force-Placed Insurers
- Contract underwriters
- Appraisal & Review
- Title/abstract
- Notary
- Law Firms
- Foreclosure Trustees

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Managing Third-Party Risk and Compliance

"Service Provider" (Continued)

Accounting

Appraisal Management

Internal Audit

Human Resources

Loan Review

Asset Management

Other consultants

Courier Services

Records Management & Storage

Compliance systems providers

Mortgage Brokers (whose?)

R.E. Brokers?

Correspondents?

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Special Problems of Managing Law Firms

Key Questions:

1. What is the size of the law firm?
2. What is the nature of the work the lawyers hired to perform?
3. How much contact with consumers do the lawyers have?
4. What are the lawyers’ fiduciary duties in the engagement?
5. How is the work performed? (Lawyers v. Paralegals)
6. What is the volume of work performed? (How many matters?)
7. What consumer laws are applicable to the work?
8. What are the channels of communication with the law firm?
9. Who is managing the relationship in your company?
10. Who is managing the relationship in the law firm?

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"Federal Consumer Financial Law"

- Defined in § 1002(14) of the Dodd-Frank Act (15 U.S.C. § 5481(14)).
- Includes: Provisions of Dodd-Frank itself, Alternative Mortgage Transaction Parity Act, Consumer Leasing Act, Electronic Funds Transfer Act, Equal Credit Opportunity Act, Fair Credit Reporting Act, Fair Debt Collection Practices Act, Section 43 of Federal Deposit Insurance Act (subsections (b)-(f)), Sections 502-509 of Gramm-Leach-Bliley Act, Home Mortgage Disclosure Act, Home Ownership and Equity Protection Act of 1994 (HOEPA), Real Estate Settlement Procedures Act (RESPA), S.A.F.E. Mortgage Licensing Act, Truth In Lending Act (TILA), Truth in Savings Act, Interstate Land Sales Full Disclosure Act, Section 626 of the Omnibus Appropriations Act, 2009, and "any rule or order prescribed by the Bureau under this subchapter."

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"Business Relationships With Service Providers"

- Not expressly defined; instead, the following vague paragraph:
- "The CFPB recognizes that the *use* of service providers is often an appropriate business decision of supervised banks and nonbanks. Supervised banks and nonbanks may *outsource certain functions* to service providers due to resource constraints, *use* service providers to develop and market additional products or services, or *rely on* expertise from service providers that would not otherwise be available without significant investment." (Emphasis added.)
- Contract required? Apparently not.
- Expansion also to "marketing partners" such as sellers of ancillary insurance products that are not true vendors.

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“Supervisory Authority Over Service Providers”

- “Title X authorizes CFPB to *examine* and *obtain* reports from supervised banks and nonbanks for compliance with Federal consumer law and for *other related purposes* and **also** to exercise its enforcement authority when violations of the law are identified.” (Emphasis added.)
- “Title X also authorizes CFPB supervisory and enforcement authority over supervised service providers, which includes the authority to examine the *operations of service providers on site*.” (Emphasis added.)
- “The CFPB will exercise the full extent of its supervision authority over supervised service providers, including its authority to examine for compliance with Title X’s *prohibition on unfair, deceptive, or abusive acts or practices*.” (Emphasis added.)
- “The CFPB will **also** exercise its *enforcement authority* against supervised service providers *as appropriate*.” (Emphasis added.)

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“Supervised Service Providers”

- Service providers to supervised banks and nonbanks (12 U.S.C. § § 5515, 5514)
- Service providers to a *substantial number* of small insured depository institutions or small insured credit unions (12 U.S.C. § 5516) (Emphasis added.)

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- CFPB Enforcement Options (Tools):
    - Conduct Investigations
    - Initiate and Conduct Administrative Hearings
    - Initiate and Conduct Civil Litigation
    - Criminal Referrals

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CFPB Enforcement Options (Remedies):

- Cease and Desist Orders

  (Including temporary “cease and desist” orders)

- Civil Money Penalties (Per Violation):
  - Up to $5,000 per day during which violation occurred
  - Up to $25,000 per day for reckless violations;
  - Up to $1 million per day for knowing violations
- Recovery of Costs in Civil Actions

(Continued)

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CFPB Enforcement Options (Remedies Continued):

Other Available Remedies

– Rescission or reformation of contracts

– Refund of money or return of real property

– Restitution

– Disgorgement of compensation for unjust enrichment

– Damages or other monetary relief

-- Limits on activities and functions

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CFPB Enforcement Action Against Capital One:

Capital One's marketing practices for credit card add-on products such as payment protection and credit monitoring. CFPB alleged that Capital One's third-party agents used deceptive marketing practices to pressure or mislead consumers to pay for these add-on products and that Capital One failed to provide proper oversight.

Penalties:

-- Cease & Desist from marketing and solicitation of add-on products until

submits compliance plan to CFPB

-- Refund $140 Million to customers (CFPB)

-- Refund an additional $10 Million (OCC)

-- Pay $25 Million Civil Penalty to CFPB

-- Pay $35 Million Civil Penalty to Comptroller of the Currency (OCC)

-- Hire independent auditor to monitor compliance

In total, Enforcement Action cost Capital One $210 Million---10 times more than the largest settlement ever obtained by the FTC

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Old Contracts/New Laws

- Contractual duties in old contracts may not match new requirements
- Modification of old contracts may open renegotiation of sensitive terms
- What about the vendor’s contracts with its vendors?
- Issues of privacy and confidentiality
- The problem of over-reliance on contract obligations
- What are your remedies?
- What does the CFPB require?

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“Compliance Management Systems”

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CONCLUSION

"Consumer financial protection is the CFPB's singular focus."

---CFPB Strategic Plan 2013-2018

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The Latest on Third-Party Risk Management (TPRM) and Vendor Oversight:

Heightened Regulatory Expectations

- **Richard Koch, *Senior Vice President***

Operational Risk Assessments

Morningstar Credit Ratings, LLC

ACI's Bank and Non-Bank Forum
on Mortgage Servicing Compliance

Washington, D.C.
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What role does a third party provider play?

- Third party servicer providers play an integral role in the residential mortgage servicing industry.
- Vendors are utilized at nearly every stage of the mortgage servicing life cycle and include:
    - Technology providers: 70% of mortgage loans serviced on vendor systems.
    - Escrow administration: Hazard and flood insurance, real estate taxes, homeowner assessment (HOA) bill procurement and payment, payment processing lockbox vendors, billing and statement printers.
    - Customer service: Third party call centers
    - Default management life cycle: Collectors, loss mitigation counselors, field service personnel, property management, bankruptcy and foreclosure representation.

Why use a third party service provider?
Cost benefit analysis for service companies:

- Extensive financial investment in hiring, training and supporting an internal staff of knowledgeable professionals.
- Significant startup investment in technology.
- Cost to develop a compliance-oriented business culture to comply with pervasive Consumer Financial Protection Bureau (CFPB) and other regulatory requirements.
- Extensive startup time to develop the requisite infrastructure and enterprise-wide management and performance measurement systems and protocols.

Why use a third party service provider? Brain power, business expertise and compliance knowledge

- Provides a ready pool of educated employees well-versed in the applicable loan servicing best practices.
- Eliminates the significant time and financial investment in building it internally.
- Ability to 'load balance' during volume lows and peaks, minimizing expense of maintaining excess capacity.
- Provide a strong compliance culture where the vendor is the 'expert' and you should be able to rely on that expertise.
- Agility and flexibility when bringing new products to market.

Third party service providers: Evaluation factors we consider

- Centralized vs Decentralized oversight model
- Third party service provider review, selection and approval process
- Annual recertification process
- Establishing comprehensive service level agreements
- Key performance indicators: incentives and penalties
- Monitoring vendor performance, scoring and providing feedback

Third party service providers: Managing Risk

- Customer-centric functions present enhanced risk: Is your third party service provider in compliance with all of the CFPB rules?
- Industry issues such as administrative fee sharing (lender placed hazard insurance) and ineffective loan modification processing.
- Inaccurate bankruptcy proof of claims (quality control process)
- Improper or incomplete foreclosure affidavit and notarization processes (Robo-Signing)
- Heightened regulatory scrutiny and pervasive CFPB/OCC rules and oversight means that the functions you outsource by extension are scrutinized as well.

Third party service providers: Managing Risk (cont'd)

- The vendor's performance should meet or exceed key performance indicators as established in the service level agreements.
- Feedback: Does the vendor provide daily performance reporting?
- If customer-centric work is involved, can the client monitor calls?
- How frequently does the servicer meet with the third party service provider to review performance?
- Does the servicer periodically complete a scorecard to evaluate the third party service provider's performance?

Third party service providers: Managing Risk (cont'd)

- Increased regulatory oversight and complexity creates new demands on the servicers and their third party service providers relationships. The need to develop "partnerships".
- Servicers need to expand the internal role of legal, compliance, information technology, and audit within the vendor oversight framework.
- Vendor performance data, scorecards and servicer-vendor feedback must be 'looped' back among quality control, internal audit, information technology, compliance and legal areas.
- Servicer's epicenter should be a centralized vendor oversight function rolled up into a pervasive enterprise-wide corporate governance initiative.

Third party service providers: Managing risk through oversight

- Vendor oversight review analyzes ongoing business viability, financial stability and is in compliance with CFPB/OCC and other mortgage servicing rules and industry best practices.
- A viable third party service provider oversight program should include the following:
  - Evidence of proper insurance coverage
  - Organizational matrix and key bios of executive and senior management
  - Capacity: Number and size of current business relationships
  - Management succession plan

Third party service providers: Managing risk through oversight (cont'd)

- Processes for ensuring file security and confidentiality of borrower/customer data (Graham-Leach-Bliley)
- Employee and management turnover data
- A review of policies and procedures, training curriculum and staffing needs
- Disaster recovery and business continuity plan and evidence of successful testing
- Network security and intrusion testing protocols
- Audit and quality control reports; SSAE16 report
- Audited and pro forma financial statements (SEC Forms 10-K and 10-Q where available)
- Systems architecture and capacity for business growth in line with business projections and new product rollouts

Third party service providers: Managing risk through oversight (cont'd)

- Review and certification of policies for sub-sourcing or outsourcing work to another third party service provider domestically or offshore
- Telephony and fax capacity sufficient to handle customer volume
- Fair Debt Collection Practices Act (FDCPA) training for all personnel in customer-centric functions
- Review fees that are assessed and ensure that they are reasonable and customary in relation to industry standard
- Monthly number and type of regulatory inquiries/complaints
- Monthly number and type of incoming litigation

Third party service providers: Conclusion

- Develop a centralized vendor oversight function that reviews third party service providers on a periodic basis for effective performance management in accordance with service level agreements as well as effective compliance with local, state and Federal laws
- Ensure that centralized vendor oversight function is enterprise-wide and encompasses the relevant servicing areas as well as legal, compliance, information technology and audit to provide a continuous feedback loop.

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The Latest on Third-Party Risk Management and Vendor Oversight
Heightened Regulatory Expectations

Presented By

Michelle Leigh, *Managing Director & Senior Vice President*

Internal Controls, Regulatory and Exam Management

Union Bank

Statistics….

Complaints Filed Through the CFPB Website from December 1, 2011 through March 2014:

208,474

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Statistics….

Complaints Filed Through the CFPB on Mortgages Only from December 1, 2011 through March 31, 2014:

95,948

So the question arises…."how many of these occur with third-party relationships? The answer: Almost half!

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Rules of the Road….

- So, as a bank or non-bank in today's marketplace, how can we possibly capture ALL of the regulatory requirements regarding our third-party relationships?

- **IS** that really possible?

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Rules of the Road….

YES, it’s possible! But, there are a few things that your lines of business need to know first!

First, in order to properly evaluate your third-party relationships, it helps to segregate them into three basic areas:

a. Single Service Providers

Single service providers will include any third party business entity’s that provide one or more services to your business. They can range from tax vendors, insurance vendors, flood vendors, collection field call vendors, trustee vendors, etc..

b. Loans Serviced by other Business Entities

Loans serviced by other business entity’s include both sub-servicing relationships and vendor servicer relationships. It is imperative to ascertain which type of relationship your organization may be engaged in when working with and managing each business entity. The contract between your organization and the other business entity’s should clearly define the roles and responsibilities.

Rules of the Road….

c. Loans Serviced by other Business Entities, continued….

If your organization owns the *servicing rights*, and another entity is servicing the loans, it is a sub-servicing relationship and your organization is the "master servicer".

If the *servicing rights* are owned by the servicing entity or another business entity, and your organization owns the loans themselves, then it is a vendor relationship and your organization is the "investor".

The reverse is also true.

*Sub-servicing relationships have even greater risk than vendor management relationships have.

d. Attorney Vendor Relationships

Attorney vendor relationships will include any services provided by attorney's. These can include attorneys that provide legal services, foreclosure attorneys, trustee attorneys and attorneys that provide typical day-to-day "business as usual" services.

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Vendor Management….A whole New Science:

We've all heard of "vendor management" and/or managed vendors personally in our career histories in this industry. However, never before have we been asked, much less **mandated**, to manage our vendor relationships and work performance with the depth and breath that we are required to today. Vendor Management has become a whole new science.

WHY?

Well, the first answer to this question is usually apparent to all. "To protect our clients from harm"!

There has been tremendous harm done to clients by vendors, particularly in the last decade, and most of it has gone unnoticed and unprotected by banking and non-banking institutions. This is very scary considering that, although the harm may have been done by the vendors that the institutions have hired, the institutions carry the "lion's share" of the responsibility for this. Today, the new rules that have been written by regulators have ensured that there is no question about who *they* hold responsible and what some of the penalties for failure may mean to an institution.

What the Federal Regulators have to say about Third-Party Relationships…

“The Consumer Financial Protection Bureau (‘CFPB’) expects supervised banks and nonbanks to oversee their business relationships with service providers in a manner that ensures compliance with Federal consumer financial law, which is designed to protect the interests of consumers and avoid consumer harm. The CFPB’s exercise of its supervisory and enforcement authority will closely reflect this orientation and emphasis.” **CFPB April 2013**

“The Office of the Comptroller of the Currency (OCC) expects a bank to practice effective risk management regardless of whether the bank performs the activity internally or through a third party. A bank’s use of third parties does not diminish the responsibility of its board of directors and senior management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws.” **OCC October 2013**

“The use of service providers does not relieve a financial institution's board of directors and senior management of their responsibility to ensure that outsourced activities are conducted in a safe-and-sound manner and in compliance with applicable laws and regulations. Policies governing the use of service providers should be established and approved by the board of directors, or an executive committee of the board. These policies should establish a service provider risk management program that addresses risk assessments and due diligence, standards for contract provisions and considerations, ongoing monitoring of service providers, and business continuity and contingency planning.” **FRB December 2013**

Vendor Management….A whole New Science:

What is so "different" about managing vendors today versus in prior years?

The main thing that makes vendor management so different from prior years is the fact that banks and non-banks are required to manage vendors AND their vendor's vendors.

Examples: There could be an institution that has an LSBO ("Loans Serviced By Others") or a Sub-Servicer servicing a pool of loans that they own. Not only do they have to "manage" the LSBO/Sub-Servicer, but also:

- If that loan has gone into default and requires a *collection field call* as part of routine collection efforts, the institution will also have to "manage" the collection field call vendor to ensure compliance.
- If that same loan continues to decline and foreclosure is imminent, the institution will have to "manage" a potential foreclosure attorney as a vendor to ensure compliance.
- If that same loan has a lapse in flood or hazard insurance during the foreclosure, the institution will have to "manage" the flood or hazard insurance vendor to ensure compliance.
- If that same loan has gone through foreclosure and a trustees sale has occurred, the institution will have to "manage" the trustees sale company to ensure compliance.

In other words, to ensure proper vendor management, the institution must **follow the client** from vendor to vendor!!

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Vendor Management….A whole New Science:

Does an institution have to “follow” every client in order to properly manage vendors?

No, not at all. However, when a vendor is going through the initial “vendor approval process” within an institution, the institution should obtain and carefully review the following items, at minimum:

- The business entity’s Quality Control “QC” Manual to monitor all applicable business practices and adherence to laws and guidelines;
- The business entity’s own Vendor Management Program;
- The Quality Control Manuals for any *vendors* that the business entity may use;
- Operational Policies and Procedures for all levels of vendors involved;
- Any Regulatory history and reports they are willing to share;
- Any Legal issue information shared or discovered;
- The internal Quality Assurance “QA” Reports and Score Carding (that each vendor performs on the vendors they hire (the vendor’s vendor) to monitor compliance and trends, ensuring there was no harm to their client and no regulatory violations.

In other words, a foreclosure attorney should be monitoring the day-to-day activities, through their own QA process and/or a Score Card process, the trustees sale company they have hired to perform trustee services. They need to monitor for ongoing compliance and to ensure the client was not harmed by any unlawful activity.

Vendor Management….A whole New Science:

And remember…..

It is just as important to monitor third-party relationships at a *business level* as it is a *transactional* and *vendor use* level!

Audit your third-party relationships, using your own Organization's test scripts for business practices, compliance and business-level "due diligence" !!

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Vendor Management….A whole New Science:

So, what happens after the initial vendor approval process? What happens next?

What happens next is the ongoing management of the vendor relationship and continuous process review (i.e., "management") to ensure there is no client harm and no unlawful activity. This can be done on a monthly or quarterly basis.

This is a HUGE responsibility!! How can this be made as easy as possible, while being thorough in our efforts?

Consider the possibility of spreading the responsibility among the many. This brings up the old saying of "Many hands make light work".

This means having each of your lines of business do an ongoing monthly "QA" of their own vendors for their areas (After all, *they* are the experts, anyway!). Depending on the riskiness of the subject matter and tasks the vendor is performing, along with the volume they are handling, your lines of business can determine a monthly selection size and perform a short list of QA reviews with specific and pertinent questions. Month over month, this will provide some trends from the vendors that should be reported to senior management.

The regulators will ask to see evidence of ongoing and strong management of vendors!! And, vendor's vendors!!

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How has this affected Banks and Non-Banks Lines of Business?

Best Practices:

The servicing rules call for much ***tighter guidelines*** to ***protect our consumers*** from the harm that has befallen them in the past; and this ***harm has often occurred without the banks/non-banks even being aware of it because it occurs in a third-party relationship . These changes have challenged the entire industry in many ways. Some of these ways include:***

- ***Creating task forces and work streams to*** think through, build out and implement new or enhanced process flows.

- ***Hire more FTE's and/or Consultants to perform the*** *wo*rk itself, which usually includes having ***to hire people with "greater" levels of knowledge and experience as it relates to risk.***

- ***Build or increase Internal Control Programs*** to better manage all areas of risk, including ***Federal and State Compliance, GSE Guideline Compliance, FHA Compliance***, possible other areas of compliance, ***always including both legal and reputational risks.***

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Regulator Perception….

If you read between the lines there is a small, ongoing whirlwind in the room that threatens to grow larger.

It is not necessarily violating the federal regulations - although it could be; it is not necessarily your servicing system - although it could be, and it is not the writing or lack of any policy or procedure - although it certainly could be. These are all important!

It is actually how you may be **perceived** by your regulators at running your department and lines of business. How you handle customers on the phone. How you return their phone calls. How seriously do you take their complaints or how much information is given to the customers and in what format. Is it clear concise, legible and easily understood?

It's about your basic treatment of your customers. Regulators can see this clearly through their examinations of your operations.

It is all, for lack of a better words, very subjective; you know a jump ball of sorts. Today, we have to be smarter, faster, and more knowledgeable.

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Regulators On-Site:

So, when my Regulators are on-site looking at my Third-Party Relationship monitoring, what are some examples of what they want to see?

1. To assess your organization's quality of compliance risk management systems, including internal controls and policies and procedures, for preventing violations of Federal consumer financial law in the **mortgage business**. Then they will look to ensure that you are monitoring for these same items within your third-party relationships.

2. To identify acts or practices within your organization that materially increase the risk of violations of Federal consumer financial law in connection with mortgage business. Then they will look to ensure that you are monitoring for these same items within your third-party relationships.

3. Gather facts that help determine whether a regulated entity engages in acts or practices that are likely to violate Federal consumer financial law in connection with mortgage business. Then they will look to ensure that you are monitoring for these same items within your third-party relationships.

4. To determine, in connection with Headquarters, whether a violation of a financial law has occurred and whether further supervisory or enforcement actions are appropriate within your organization or in any of your third-party relationships.

How am I handling the attention and focus by the CFPB, other Federal regulators and State regulators?

In addition to your own organization, you must ensure that your third-party relationships are:

- **Training working teams to understand the need to be extra attentive to what the *real* issues are with customers. Giving them the knowledge, skill sets and training that they need. Are they armed with solid training in the ability to listen and respond appropriately to customers?**

- **Giving working teams subject matter experts to rely upon. And, ensuring the subject matter experts are given every opportunity to excel. If you find that someone who you thought would be a good subject matter expert is unable to perform or help employees with their questions, issues and projects, consider finding another position for them. Today, no one can afford to have subject matter experts that are not up to the task.**

- **Requiring working teams to answer the phone as it rings and to be pleasant and caring. Most of the calls that come in are from people with an issue that needs to be resolved. And, these callers have heard enough from the media to be looking for a "fight" as they believe that all servicers do not care. Show them that you care. Listen.**

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How am I handling the attention and focus by the CFPB, other Federal regulators and State regulators?

In addition to your own organization, you must ensure that your third-party relationships are:

- Asking working teams to spend enough time to resolve the issue, or be timely in getting back to the customers with an update. Not only because it's regulation, but because it's the right thing to do!

- Ensure that working people document all of the conversations and actions taken with customers. Make sure they are dated and time stamped. They need to spend enough time to ensure accuracy of information.

- Provide working teams with current Policies and Procedures for reference. Ensure they have read and understand them. Weekly training meeting help in this understanding. Obtaining sign off from teams after they have read them also help and regulators will often ask for this evidence.

- Ensure working teams are always professional and respectful to answer each question thoroughly. Ensure they know the answers *before* they begin answering the questions so that they are accurate.

- Educate working teams with "teaching moments". When a specific issue has arisen and is resolved, I try to capture the moment instantly and use that for training.

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Operational Risk Model and Infrastructure/Operationalizing Regs

A key component in the *success of this transition into a stronger, more robust organiz*ation, is the *basic understanding* that one *must "operationalize" the Regulations/Laws/Rules*. Many *institutions, mine included*, have *three lines of risk defense*. They are:

First Line of Defense: Sits at the line of business level, but operates independently of them, which gives them the ability to monitor/audit/test both at a transaction and business process level, which is performed on a monthly basis. They generally have a "dotted line" to the Compliance Managers at a corporate level.

These groups generally consist of FTE's that possess both business operational knowledge, as well as compliance knowledge. For lack of better words, they have one foot in each doorway. This is the group that is best postured for assisting the lines of business with successful operationalizing of the Regulations/Laws/Rules. This group is equally adept at assisting the lines of business with remedial efforts – without having to own the process. They also perform ongoing risk analysis on business process.

Do your third-party relationships structure their organizations in a similar fashion? Do they at least have the same components in Order to help the business "operationalize" regulations?

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Operational Risk Model and Infrastructure/Operationalizing Regs

Second Line of Defense: Sits at a corporate level, operates completely independent of all other groups. These groups are comprised of Compliance Officers, often with extensive compliance experience, but limited line of business knowledge or experience. They perform periodic audits of the line of business activity and have intermittent testing oversight of the First Line of Defense, which enables them to perform less frequent audits and cover broader areas of the organization.

Third Line of Defense: Sits at a corporate level, operates completely independent of all other groups, and are usually known as "Internal Audit". These groups are comprised of Internal Auditors and CPA's, with a broad range of organizational knowledge and experience, including financial advisory experience. Their mission is to audit the lines of business, the first and second lines of defense, and they have the broadest audit scope of all the other groups, covering the entire organization, end to end.

Besides your own organization's mission to monitor your third-party relationships practices, who are the oversight groups within your third-party relationships internal structures? Where do they sit? How often do they monitor? How often do they risk assess? How often do they perform testing?

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Banks and Non-Banks….Federal Laws vs. State Laws:

Banks and Non-Banks:

With respect to the differences between what is being required of banks and non-banks, while there are some differences in which regulators have governance over them (i.e., the CFPB, OCC, Federal Reserve Bank, State Regulators, etc.) and some of the rules will differ, all have heightened requirements that must be complied with regarding third-party relationships.

Federal Law vs. State Law – Which one trumps? VERY CONFUSING

There are also differences between some state and federal regulations, which can impact the same business activity, and which carry different requirements.

In those cases, the institution would be required to follow the law that is the most strict, which can at times be a state law. The institution must also encompass the components of the federal law (which may be absent from the state law), and therefore, would be able to capture **all** of the necessary components to create a full body of laws to adhere to.

Contacting your Legal Departments can often help you with interpretations of the law, as well as factoring in the components of each area of the differing laws.

Banks and Non-Banks

Commonly asked questions and basic facts:

1. **Regarding best practices and the line of defense theory, how have you found the responses to be from regulators when they are on-site performing their exams and learn about this structure?**

A: It has been our experience that THEY LOVE IT! Historically, Compliance Departments alone have usually been able to identify where there is non-compliance of the regulations, but it is rare when they also know the business practices well enough, giving them the ability to inform the Lines of Business "LOB" *how* to remediate the problem at a business level, as well as "operationalize" the regulations.

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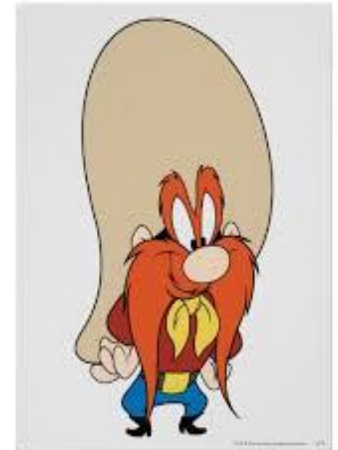
Banks and Non-Banks

2. **Some people say that the different regulators are "working together". Have you found that to be true?**

A: The answer to that is, "at minimum, they work together indirectly". When your institution receives their First Day Letter, which is the letter that regulators issue stating when they will be coming on site to perform an examination and where they ask for numerous documents containing different information about the business it's transactions. Your institution will usually be asked about:

(a) Previous Regulatory Exams;
(b) Which Regulator(s) performed the examination;
(c) What the subject matter was;
(d) Were there any violations;
(e) What level of seriousness were the violations (MRA or MRIA), and,
(f) What is the remedial plan and date of completion.



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Unfair, Deceptive And Abusive Practices ACT “UDAAP”….

UDAAP is defined as risks that may include potential **u**nfair, **d**eceptive, or **a**busive **a**cts or **p**ractices with respect to services interactions with consumers. The examination process will include assessing these types of risks that are not governed by specific statutory or regulatory provisions.

Just to re-define again:

Deceptive

- Likely to mislead a consumer
- The customer’s interpretation is reasonable under the circumstances
- The practice is material

Unfair

- Causes or is likely to cause substantial injury to consumer
- The injury is not reasonably avoidable
- The injury is not outweighed by countervailing benefits

Abusive

- A lack of understanding of the material risks
- The inability to protect their interest in selecting or using a consumer financial product
- The reasonable reliance by the consumer on a covered person to act in the consumer’s best interest

Change Management….A very old process that has an “official” new name:

I hear the term “Change Management” so often now, but I’m not exactly sure what that means (??). Can you clarify that term?

“Change Management” is the terminology used when any kind of “change” takes place within the regulatory laws – both state and federal, and/or the agency guidelines, as it relates to *operationalizing* those changes into the business processes and reflecting the changes within Policies and Procedures.

Change Management, however, is not only limited to these areas. Change Management also comes into play when internal controls testing of any kind (regulatory, agency, FHA, ORM, etc.) results in exceptions and/or violations identified and where a remedial plan is required; hence, the “change” in Change Management. It is the operationalizing of whatever the change must be and it must be in full compliance with all laws and guidelines.

We have brought this up because, during a regulatory examination, your organization will likely be asked to provide policies and procedures information surrounding the Change Management process. They will also ask you about what your third party relationships practices are around Change Management.

The regulators want to ensure that, with as fast as all of the newer regulations and guidance are being presented, institutions have a solid and sustainable business practice to handle and implement change accordingly.

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The Future…..

New CFPB Ruling: Coming August 2015

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Questions….

Questions ?

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