Supervision of Service Providers - CFPB Guidance

Executive Summary

The Bureau of Consumer Financial Protection's ("CFPB" or "Bureau") Bulletin 2012-03 outlines the CFPB's expectations for business relationships between service providers and the banks and nonbanks under the CFPB's supervision and enforcement authority ("supervised banks and nonbanks"). In general, the CFPB expects supervised banks and nonbanks to oversee relationships with their service providers to ensure the service providers comply with Federal consumer financial laws and operate in a manner that protects consumers and avoids consumer harm. The CFPB states the legal responsibilities for failure to comply with the laws or to protect consumers, in some cases, may lie with the supervised bank or nonbank in addition to the service provider.

Background

Sections 1024, 1025 and 1026 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") give the CFPB supervisory and enforcement authority over the service providers to those banks and nonbanks under its direct supervision as well as those that provide services to "a substantial number" of small insured depository institutions or small insured credit unions supervised by the prudential regulators (collectively, "supervised service providers"). The Dodd-Frank Act defines a service provider as any person that provides a material service to any person that engages in offering a consumer financial product or service in connection with the provision of that product or service. Service providers may be affiliated or unaffiliated with the supervised bank or nonbank and may provide a variety of functions such as: payments processing, customer call center operations, marketing relationships to provide products and services not otherwise provided by the supervised entity (e.g., mortgage brokers, credit card providers), loan servicing, debt collection, disclosures preparation and compliance reviews.

The CFPB's expectations for service provider relationships outlined in Bulletin 2012-03 closely track the broad principles previously outlined by the Office of the Comptroller of the Currency ("OCC") in its Bulletin 2001-47 as essential components of a "well-structured risk management process" for third-party relationships (i.e., service provider and vendor relationships). The long-standing guidance outlines the increased risks that can arise from reliance on third-party relationships (including strategic, reputation, compliance, credit, and transaction risks) and the OCC's supervisory expectations regarding a bank's efforts to control for that risk to protect its

safety and soundness. The OCC states that "many third-party relationships should be subject to the same risk management, security, privacy, and other consumer protection policies that would be expected if a national bank were conducting the activity directly."

Notably, in contrast to OCC Bulletin 2001-47, the CFPB's guidance contains very little detail to direct compliance with its expectations, imposes no materiality criteria based on the level of risk posed by the service provider, and is uniquely focused on regulatory compliance with Federal consumer financial laws.

In May 2012, the Federal Reserve Board ("Fed") conducted a Webinar entitled, "*Vendor Risk Management – Compliance Considerations*," in which it acknowledged the increasing use of third party vendors to provide critical functions and reiterated the position that financial institutions retain ultimate responsibility for compliance. The Fed noted that compliance risks and risks to consumers are heightened through service provider relationships when the service providers are:

- Positioned directly or indirectly between the supervised entity and the consumer;
- Deeply involved in the delivery of products and services to the customer;
- Unrestricted with regard to accessing customer information; and
- Not subject to adequate monitoring.

The Fed stated that a financial institution should have a program in place to ensure that vendors comply with Federal banking laws and regulations, as well as to fully understand how the vendors' activities impact consumers. The Fed suggested that, as a "good rule of thumb," financial institutions should oversee vendors as they would any other division in the bank.

Description

As outlined in Bulletin 2012-03, the CFPB expects supervised banks and nonbanks to have a process in place to manage the risks associated with service provider relationships. The process should include, but not be limited to:

- Due diligence to verify that the service provider understands and is capable of complying with Federal consumer financial law;
- Review of the service providers policies, procedures, internal controls, and training materials to ensure that the service provider is conducting appropriate oversight and training of employees or agents that have consumer contact or compliance activities;
- Clear expectations for compliance with Federal consumer financial law stated in the service provider contract along with "appropriate and enforceable" consequences for violating any compliance-related responsibilities, including engaging in unfair, deceptive, or abusive acts or practices ("UDAAP");
- Internal controls and ongoing monitoring to determine whether the service provider is complying with Federal consumer financial law; and
- Prompt corrective action to fully address problems identified through the monitoring process, including terminating the relationship where appropriate.

Commentary

The release of CFPB Bulletin 2012-03 closely followed by the Fed's Vendor Risk Management Webinar, sends a clear message to the financial services industry that the Federal banking regulators intend to look closely at service provider relationships and that they expect financial institutions to have programs in place to actively monitor and test the capability of those service providers to comply with Federal consumer financial laws and to protect consumers. This heightened interest is likely borne out of and supported by the enforcement actions/Consent Orders initiated by the OCC and Fed (and Office of Thrift Supervision) in 2011 and the March 2012 Servicer Settlement Agreement reached by the Attorneys General in 49 States, the Department of Housing and Urban Development and the Department of the Treasury with the five largest mortgage servicers, as well as the consumer protections, operating standards and remediation requirements for cases of consumer harm that resulted from each of these actions.

The CFPB's expectations, which are consistent with existing regulatory guidance, should be familiar to supervised banks and their service providers. Though when considered in combination with the heightened focus on third-party management resulting from the mortgage Consent Orders and also the Servicer Settlement Agreement, supervised banks and their service providers should expect increased scrutiny and anticipate a need to enhance and strengthen their third-party management programs. Supervised nonbanks and service providers not otherwise affiliated with supervised banks have generally not been subject to Federal oversight and will now be required to meet these expectations (i.e., comply with consumer laws and protect consumers from harm) under the heighted supervisory interest or face enforcement action for failure to do so. The CFPB indicates that it intends "to exercise the full extent of its supervision authority over supervised service providers," which includes authority to examine the service provider on-site for compliance as well as conduct in violation of UDAAP.

As noted above, unlike the earlier OCC Bulletin 2001-47, the CFPB's Bulletin 2012-03 is not detailed and provides little guidance beyond the expectation that all service providers are expected to meet all requirements of the Federal consumer financial laws and that supervised banks and nonbanks are required to ensure that their service providers are able to meet the requirements. This could prove to be a daunting task requiring significant resources, especially for nonbanks not used to providing such oversight or service providers not used to close scrutiny, given that no risk-based applications or frequencies are provided in the guidance.

Supervised banks and nonbanks should review their vendor and other third-party service provider relationships to ensure compliance with the CFPB Bulletin guidance, as well as with the guidance provided through the Consent Orders and Servicer Settlement Agreement. Any identified remedial actions should be taken as appropriate. Reviews should include at a minimum:

- Assurance that the supervised entity has a program in place to manage the risks from service providers (including selection of service providers, risk assessment, contract structuring and review, monitoring, training and reporting).

- Review of the service provider contract to ensure expectations for compliance with Federal consumer financial law are clearly stated along with "appropriate and enforceable" consequences for violating any compliance-related responsibilities, including UDAAP.
  - Contracts should ensure the right to audit the service provider and to conduct monitoring/testing activities.
- Due diligence procedures to verify that the service provider understands and is capable of complying with Federal consumer financial law, including for example:
  - Reviews of the service provider's policies and procedures; and
  - Other reviews such as, management interviews, "process walk-thrus" and documentation of controls.
- Ongoing monitoring to determine whether the service provider is complying with Federal consumer financial law, including the receipt and resolution of consumer complaints. Example procedures might include:
  - Transactional file reviews and simulated transactions;
  - Internal controls reviews;
  - Reviews of training materials; and
  - Call monitoring.

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