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Financial Institution Compliance Update

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This communication is designed to provide you with quick snapshots and timely perspective on recent regulatory developments.

Regulatory Bulletin Update: CFPB Provides Guidance on Supervision of Service Providers

On June 27, 2013, the Consumer Financial Protection Bureau (CFPB) reached an agreement with U.S. Bank and its partner, Dealers' Financial Services, regarding an allotment fee charged to participants in the Military Installment Loans and Educational Services (MILES) auto loan program. This reflects the implementation and enforcement of CFPB Bulletin 2012-03 issued on April 12, 2012, which outlines the CFPB's expectations on business relationships between service providers (vendors and other third parties), the banks, and nonbanks under the CFPB's supervision and enforcement authority. The CFPB expects supervised banks and nonbanks to oversee relationships with their service providers in a manner that ensures compliance with Federal consumer financial laws, operate in a manner that protects the interest of consumers and avoid consumer harm. The CFPB states that legal responsibilities for failure to comply with the laws and to protect consumers lies with the supervised banks, nonbanks and with the service providers.

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Background

Sections 1024, 1025 and 1026, of the Dodd-Frank Wall Street Reform and Consumer Protection Act, gave the CFPB supervisory and enforcement authority over the service providers that provide outsourced services to banks, nonbanks and small insured depository institutions under its direct supervision. 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 outsourced functions such as: skip-tracing, payments processing, customer call center operations, and marketing services that are not directly provided by the supervised entities.

The CFPB Bulletin 2012-13 shares similar broad principles outlined in the Office of the Comptroller of Currency (OCC) Bulletin 2001-47 regarding a well-structured risk management process for service providers. The OCC states that many service providers 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 activities directly" to ensure that the risks, including strategic, reputation, compliance, credit and transaction risks, are properly mitigated.

The Federal Reserve Board (FRB) conducted a 'Vendor Risk Management - Compliance Considerations" Webinar in May 2012, in which they acknowledged the increasing use of service providers that provide critical functions and reiterated the position that financial institutions retain ultimate responsibility for compliance. The FRB noted that compliance risks to consumers are heightened through service provider relationships that 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 and risk assessments.

The FRB stated that a financial institution should have a vendor management program in place to ensure that vendors comply with Federal banking laws and regulations, as well as to fully understand how the service providers' activities impact consumers. The FRB suggested that financial institutions manage their vendors as they would any other division in the bank to ensure appropriate governance and oversight of their activities.

Regulatory Expectations

The CFPB's expectations, which are consistent with existing regulatory guidance, should be familiar to supervised banks and their service providers. Supervised nonbanks and service providers not otherwise affiliated with supervised banks have generally not been subject to Federal oversight and are now required to meet these expectations of complying with consumer laws and protect consumers from harm or face enforcement action for failure to do so.

The CFPB indicated that it intends to exercise the full extent of its supervision authority over supervised service providers which will include conducting on-site examination of the service providers for compliance, specifically with Unfair, Deceptive or Abusive Acts or Practices (UDAAP). 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 review to verify that the service provider understands and is capable of complying with Federal consumer financial law.
- Annual review of the service provider's 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 laws should be stated in the service provider contracts (i.e. Master Service Agreement and Non-Disclosure Agreement) 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.

Minimum Requirements of Vendor Management Program

Supervised banks and nonbanks should review their vendors and other third-party service provider relationships to ensure compliance with the CFPB Bulletin guidance, as well as guidance provided by the OCC and FRB. Any identified remedial actions should be implemented in accordance with Federal consumer financial laws. Reviews should include the following minimum requirements:

- Assurance that the supervised entity has a vendor management program in place to manage the risks from service providers, including selection of service providers, annual risk assessment, contract structuring and review, insurance certification, monitoring, training and periodic reporting.
- Review of the service provider contracts to ensure expectations for compliance with Federal consumer financial laws are clearly stated along with appropriate and enforceable consequences for violating any compliance-related responsibilities, including UDAAP. Contracts should also ensure the right to audit the service provider and to conduct monitoring and testing activities.
- Due diligence procedures to verify that the service provider understands and is capable of complying with Federal consumer financial laws. Documentation to support such reviews may include the service provider's policies and procedures, management interviews, process walkthroughs, SSAE16 (aka SAS 70) Type II Reports, and documentation of controls.
- Ongoing monitoring to determine whether the service provider is complying with Federal consumer financial laws, including the receipt and resolution of consumer complaints. Examples of ongoing monitoring may include transactional file reviews, internal controls review, and reviews of training materials and call monitoring processes.

What can your financial institution do to ensure compliance with program requirements?

As evidenced by the recent CFPB enforcement action against U.S. Bank and its partner as well as other CFPB actions, establishing and maintaining a robust Vendor Risk Management and Oversight program is an essential element of a strong Compliance Management System (CMS). For non-bank financials, it will be important to establish good controls and monitoring over key third parties to ensure a positive evaluation by the CFPB. For banks, now is the time to review the overall completeness and strength of your vendor program.

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