

CFPB's Supervisory Manual: Priorities And Procedures

Law360, New York (October 25, 2011, 12:24 PM ET) -- On Oct. 13, 2011, the newly enacted Consumer Financial Protection Bureau (CFPB) adopted its first Supervision and Examination Manual, offering regulated financial institutions a first glimpse into how the agency will seek to carry out its mandate to implement and enforce "federal consumer financial law." This article highlights points of importance to regulated companies as they prepare for the CFPB examination process.

Risk-Based Examination

The CFPB has adopted a risk-based approach to examinations, meaning that its goal is "to direct resources toward areas with higher degrees of risk." The manual thus describes the pre-examination risk assessment as a key component of the examination process. Through this risk assessment, the CFPB will evaluate the extent of risk to consumers — meaning the potential for consumers to suffer economic loss or other injuries — arising from the activities or business of the entity.

The risk assessment takes into account two principal factors: the inherent risk in an entity's particular line of business or the entity overall, and the quality of controls in place to manage and mitigate that risk. As set out in the manual, the key factors in assessing inherent risk are (1) the nature of the products or services offered to consumers; (2) the consumer segments to which such products are offered; (3) the methods of selling the products; and (4) the methods of managing the delivery of products or services and the relationship with the consumer. The assessment will also make a judgment as to the expected direction of the risk: increasing, decreasing or stable.

In making the risk assessment, the agency will collect and consider data including the volume and nature of consumer complaints against an entity, and any regulatory violations or other problems identified in prior examinations. The manual emphasizes that risk assessments will not be used "to reach conclusions about whether an entity has violated a particular law or regulation."

However, it is clear that the agency views consumer complaints — whether lodged with the agency or the entity — as an important indicator of unlawful activity. For example, the manual advises that consumer complaints "play a key role in the detection of unfair, deceptive, or abusive practices," and describes them as "a red flag indicating that examiners should conduct a detailed review of the relevant practice" — especially in cases of multiple complaints about the same product or service.

In accordance with its risk-based approach, the agency publicly announced in conjunction with the release of the manual that the initial focus of its examination efforts will be the mortgage-servicing industry. To that end, the manual includes a section outlining examination procedures specific to mortgage servicers.

Mortgage servicers will be subject to nine examination “modules,” focusing on the entity’s servicing and loan-ownership transfers, payment processing and account maintenance, customer complaints and inquiries, maintenance of escrow accounts and insurance products, credit reporting, information sharing and privacy, collections, loss mitigation, and foreclosures. The manual provides detailed procedures for conducting each examination module, which are instructive to mortgage servicers in developing compliance policies.

The agency has promised that it will continue to adopt examination procedures “organized by product and line of business.”

Focus on Compliance Management Systems

According to the manual, compliance management systems will be a focal point of CFPB examinations. Because the agency expects that every regulated entity will “have an effective compliance management system adapted to its business strategy and operations,” each examination will include rigorous review and testing of the systems in place.

Recognizing that implementation will vary from entity to entity, the manual identifies four basic components of an effective compliance management system: (1) board and management oversight; (2) a compliance program (comprised of policies and procedures, training, and monitoring and corrective action); (3) responsive handling of consumer complaints and inquiries; and (4) an internal compliance audit program.

Boards of directors will be expected to develop and administer effective compliance management systems, as detailed in the manual. CFPB examiners are charged with ensuring that the board and senior management have, among other things, demonstrated clear expectations about compliance both internally and to third-party service providers; adopted clear policy statements concerning compliance; appointed a qualified and experienced chief compliance officer and other compliance personnel; and allocated resources to the compliance function commensurate with the size and complexity of the entity’s operations and the laws and regulations to which it is subject, in addition to ensuring that all of the core components of an effective compliance management system are in place.

Directors and senior management of regulated companies should review and familiarize themselves with the guidelines set forth in the manual, as the agency has said that it will hold those individuals “ultimately responsible” for developing and administering a satisfactory compliance management system. If serious deficiencies are revealed in a company’s compliance management system, directors are the likely first target of any enforcement action and could face both monetary and nonmonetary sanctions.

The Examination Cycle

Regulated large depository institutions are subject to CFPB examinations on a regular schedule, to be coordinated with other federal and state regulators. Each institution will be assigned a "Lead Examiner," charged with monitoring information about the entity and its affiliates on an ongoing basis. The Lead Examiner is responsible for preparing and periodically updating an institutional profile, a risk assessment, and a supervision plan for the regulated entity. Each examination will be overseen by an "Examiner in Charge" (who is sometimes but not necessarily the Lead Examiner).

Nondepository consumer financial services companies will be selected for examination on the basis of identified risks to consumers, considering factors including the company's asset size, its volume of consumer financial transactions, and the extent of state oversight. In general, these examinations will be conducted with advance notice to the entity.

The agency's Nonbank Supervision Risk Analytics and Monitoring team ("RAM") is responsible for determining which industries and institutions pose the greatest risk to consumers and developing a risk-ranking of entities for use in scheduling examinations. The teams conducting these examinations will follow the same procedures used in regular examinations of depository institutions.

In addition to these routine examinations, the agency expects to conduct "target" and "horizontal" reviews. Target reviews generally will involve a single regulated entity and will focus on a particular identified issue of concern. The manual offers as an example of a situation potentially triggering a target review a significant volume of particular customer complaints. Horizontal reviews will examine issues arising from particular products or practices occurring across multiple entities.

The Examination Process

The examination process, for both depository and nondepository entities, will include the following basic steps:

- Collect and review information from within the agency and external sources.
- Request and review documents and information from the entity to be examined.
- Develop a preliminary risk focus and scope for the on-site examination.
- Conduct an on-site examination, including observation, interviews, and review of documents.
- Conduct a "closing meeting" to share findings and conclusions with management of the regulated entity.
- Assign a compliance rating (on a 1-to-5 scale).
- Prepare an examination report, subject to internal review and approval and review by other regulators.
- Share final examination report with regulated entity.
- Conduct follow-up to address negative examination findings.

The agency will treat as confidential all supervisory information, including examination reports and ratings.

Regulated companies should consider involving outside counsel early in the examination process. Outside counsel may be better situated than in-house lawyers or compliance officers to identify compliance gaps likely to raise red flags, to advise on best practices for completing the examination and working with the agency, and to address legal questions — including questions of first impression — that are likely to arise in the examination process.

Examination Follow-Up and Enforcement Procedures

The agency is authorized to investigate potential violations of federal consumer financial law independently or in conjunction with other regulators, and is empowered to subpoena testimony and documents. In addition, the agency, at its option, may address negative examination findings through either informal supervisory measures or formal enforcement action.

While the manual expresses the goal of encouraging “self-correction,” it notes that “some circumstances may nevertheless be sufficiently serious to warrant a public enforcement action.” In such instances, the agency can initiate both administrative enforcement proceedings and civil actions in federal court. These actions may seek a range of legal and equitable relief including but not limited to restitution, disgorgement, damages, civil monetary penalties, and limits on the activities of the charged person.

The CFPB does not have criminal enforcement authority, but it may refer potential violations of federal criminal law to the U.S. Department of Justice. The agency anticipates criminally referring matters involving the falsification of financial records by regulated entities, business relationships between regulated entities and countries that are the target of U.S. sanctions, and falsification of loan documents by consumers. The agency is also charged with referring potential noncompliance with tax laws to the Internal Revenue Service, and with referring discriminatory credit practices to the DOJ.

The agency has said that its Supervision and Examination Manual is a work in progress that will be continually updated as its compliance process evolves. Regulated entities would be well advised to develop or update corporate compliance policies to directly address the agency’s priority risk areas.

For example, while most regulated entities already engage in frequent internal audits, such entities should consider developing new internal audit protocols that reflect the CFPB’s goals and approaches. Regulated entities should also monitor developments in the CFPB’s enforcement approaches, particularly as the agency shifts its regulatory focus to new products and lines of business.

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