

Regulatory brief

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Joint CFPB-State Supervision: No one is below the radar

Overview

On October 9, 2013, the Consumer Financial Protection Bureau ("CFPB") announced enforcement actions, including civil money penalties against a bank and a nonbank for violating the Home Mortgage Disclosure Act ("HMDA"), a law that requires certain mortgage lenders to accurately collect and report data about home mortgage loans.¹ Although the actions ultimately arose from CFPB examinations of the companies, the CFPB's examination of the nonbank in particular was done in close collaboration with the Massachusetts Division of Banks which had also identified serious errors in the company's filings.

In addition to sending "a strong signal" against "mislead[ing] the public with erroneous data" (as stated in the CFPB's press release), these actions demonstrate that the CFPB is increasingly coordinating its supervisory activities with state regulators, as required under Dodd-Frank² and outlined in the 2013 CFPB-State Supervisory Coordination Framework ("Framework").³

As a result of the Framework and the CFPB's recent enforcement actions, many financial entities, in particular nonbanks, will need to prepare for a new supervisory environment. This means improving overall compliance management systems as well as optimizing internal processes for responding to and monitoring regulatory examinations.

The Framework establishes a process for coordinating federal and state supervision and enforcement activities for entities subject to supervision by both the CFPB and state financial regulators. The purpose of the Framework is to promote examination efficiencies and avoid duplication of supervisory activities.

¹ See CFPB Release, *CFPB Takes Action Against Nonbank and Bank for Inaccurate Mortgage Loan Reporting* (Oct. 9, 2013).

² See Dodd-Frank section 1015.

³ The CFPB and state financial regulators entered into the CFPB-State Supervisory Coordination Framework in May 2013. The Conference of State Bank Supervisors agreed to the Framework on behalf of its membership. That membership includes state financial regulatory authorities in all 50 states and some US territories.

While the Framework may seem like inside baseball, interesting only to the CFPB and state regulators, the recent enforcement actions highlight the considerable impact that coordination will have on regulated companies. Understanding this impact is important because (1) it will bring some companies into CFPB's direct line of sight for the first time; (2) some companies will face different compliance standards than what they have been accustomed to; (3) state regulators are heightening their compliance focus (even when not coordinating with the CFPB); (4) the CFPB's initial picture of companies will be influenced by state regulators' views; and (5) examination logistics will become more challenging.

This **Financial Services Regulatory Brief** analyzes the Framework's impact on regulated companies in each of these five respects, and provides strategic guidance.

What is the Framework?

The Framework is an outline of responsibilities and examination processes, based on a 2011 information sharing agreement between the CFPB and state financial regulatory authorities. It is not legally binding on the CFPB or on state financial regulators. Instead, it is intended to serve as a guide for coordinating the supervisory and enforcement activities of the CFPB and state regulators.

For banks, the CFPB's authority extends to those institutions with at least \$10 billion in assets (and their affiliates), so state-chartered banks with \$10 billion or more in assets are covered by the Framework. These institutions are already somewhat familiar with CFPB supervision and expectations.

Nonbanks, however, will be less familiar with the Framework, yet the CFPB's and states' supervisory authority over them is vast. The CFPB's authority includes nonbanks that:

- Engage in residential mortgage, private education, or payday lending markets;
- Are "larger participants"⁴ of consumer financial markets, as determined by the CFPB; or
- Pose a risk to consumers by providing consumer financial products or services.⁵

⁴ To date, the CFPB has defined "larger participants" to include credit reporting agencies, debt collection entities, and student loan servicers.

⁵ The CFPB issued final rules in July to establish the process for notifying a nonbank that it is being considered for supervision because the CFPB may have reasonable cause to determine that it poses a risk to consumers, and for

Most nonbanks under CFPB supervision are also supervised by state financial regulators and are therefore covered by the Framework.⁶

Please see the **Appendix** for detail of the Framework's key elements.

Five reasons companies covered by the Framework should care

The Framework will considerably change the regulatory environment for many of the companies within its scope, particularly nonbanks, for the following reasons.

1. Some smaller companies will come into the CFPB's line of sight for the first time.

The CFPB is a relatively new regulatory agency with a very full plate. As a result, many companies, particularly smaller nonbanks, may not yet have caught the CFPB's supervisory eye.

The Framework will change that. For example, the Framework calls for an annual joint CFPB-state regulator process of identifying nonbanks that are subject to joint examination. This process and other communications under the Framework will enable the CFPB to tap into the knowledge base of state regulators, which will bring previously overlooked companies to the attention of the CFPB. Therefore, companies that have assumed that they are operating below the CFPB's radar should reassess that assumption and get ready for CFPB scrutiny.

2. The CFPB will hold companies to different standards than they have been accustomed to.

The CFPB holds regulated entities to relatively high standards of compliance reflected in the CFPB Supervision and Examination Manual. For example, the CFPB not only conducts transactions testing for compliance, but also assesses, in nearly every

providing the nonbank a reasonable opportunity to respond. The rule also permits a nonbank that has become subject to CFPB supervision under this process to file a petition to terminate the CFPB's supervisory authority after two years.

⁶ In addition to supervising state chartered depository institutions, most state financial regulators also supervise mortgage providers and many other financial services providers, such as money services businesses, payday lenders, check cashers, and finance companies. According to the Conference of State Bank Supervisors website, "[s]tate regulators oversee 17,121 mortgage companies, 116,991 individual mortgage loan originators, and more than 105,000 additional non-depository financial services providers across the nation."

examination, a company's compliance management system ("CMS"), including its risk assessments, documented policies and procedures, and monitoring and testing activities. In fact the CFPB recently indicated that "nonbanks are more likely to lack a robust CMS, as their consumer compliance-related activities have not been subject to examinations at the federal level for compliance with federal consumer financial laws prior to [CFPB's] existence."⁷

The CFPB will also be likely to focus on how a company monitors compliance by third-party service providers,⁸ and will expect to see a well-developed complaints management process.

These expectations will be different from what many entities have seen from their state regulators, and the difference warrants a reassessment of compliance programs in advance of any CFPB attention.

3. State regulators will heighten their consumer compliance focus.

State financial supervisory authorities have broad supervisory responsibilities, and compliance with state and federal consumer financial laws is only a part of that overall responsibility. However, due to the increased collaboration with the CFPB, we expect state authorities to increase their focus on consumer protection laws, their sensitivity to emerging consumer protection issues, and their expectations with respect to compliance management systems. This will be true even when they are acting unilaterally, outside of the Framework.

⁷ See *CFPB Supervisory Highlights* (Summer 2013); see also *CFPB Supervision and Examination Manual, Part II, Section A* (v.2 October 30, 2012) for CFPB expectations for CMSs.

⁸ The CFPB has been vocal about the need for lenders to be as mindful of their vendors' consumer-facing activities as they are of their own. For example, in May 2012, the CFPB issued CFPB Bulletin 2012-03, *Service Providers*, which provides that the 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." In an accompanying statement, Director Cordray stated, "[c]onsumers are at a real disadvantage because they do not get to choose the service providers they deal with – the financial institution does. Banks and non-banks must manage these relationships carefully and can be held accountable if they break the law." Finally, it is noteworthy that non-compliance arising from vendor activities was a major issue underlying the CFPB's first three consent orders, which required payment of \$425 million in restitution and penalties.

4. The CFPB's initial picture of many companies will be influenced by state regulators' knowledge and views.

As the CFPB is a relatively new federal agency, it has limited information about many companies that state regulators know very well, particularly nonbanks. Therefore, the views of state regulators will heavily influence the CFPB's initial impressions of those companies.

This will occur, for example, when the CFPB and state regulators develop a comprehensive supervisory plan under the Framework for each joint examination. Under the Framework, such plans should include a risk assessment of the organization; results of prior examinations; review of the entity's organizational structure, internal control and compliance functions, and external audit; and a review of pending issues such as complaints, compliance with enforcement actions, or other regulatory obligations. Therefore, the process of developing supervisory plans will foster a substantial transfer of state regulatory knowledge and views to the CFPB.

To address the impact of this knowledge sharing, companies should consider how they are viewed by state regulators and how that might influence the CFPB's initial view of them. This will particularly be the case where the entity and the state regulator have a complicated history. Such a history will increase the likelihood of CFPB's involvement in future examinations of the company, or at least the likelihood of CFPB's off-site monitoring of the company.

On the other hand, state regulators' familiarity with a company can help CFPB examiners develop a more timely and accurate understanding of the company's operations, and could decrease the risk of initial adverse findings based on factual misunderstandings. Regardless, institutions should prepare to address head-on the views of the state regulator and any residual issues.

5. Examination logistics will be more challenging than ever.

The good news about coordinated examinations under the Framework is that institutions covered by it may be subjected to fewer examinations. The bad news is that the examinations that do occur will be more complicated and time-consuming. For example, while the CFPB and state regulators' areas of interest will be similar, they will not be identical. This can create a substantial challenge, particularly for entities with less experience being subject to complex regulatory examinations.

In addition, coordinating examinations is difficult and usually imperfect, even under an established framework. As a result, entities being examined should closely monitor the progress of the examination and prepare to provide regulatory authorities with complete, accurate, and timely information. While it is the regulators' responsibility to coordinate examinations and exchange information across different agencies, some of the impact of a poorly coordinated examination will fall on the examined entity. To reduce that risk, companies should take a critical look at how they monitor and respond to regulatory examinations.

Finally, it will likely take longer for the regulators to provide official examination results (as the agencies coordinate and go through their individual levels of review) and to verify that cited matters have been resolved. Despite the delay, the examined entity should take corrective actions as quickly as possible. In fact, examined entities may be able to take corrective actions for many of the concerns raised during the on-site examination (subject to verification, of course) before receiving a final report of examination.

Appendix – Key elements of the Framework

The elements of the Framework include the following:

- Regular information sharing across regulators
- Annual joint development of a list of non-depository entities potentially subject to joint examination
- Annual scheduling of joint examinations
- Designation of a single point of contact (“SPOC”) for each regulator and for each examination under the Framework
- Designation of a state coordinating committee to address situations involving regulators from multiple states
- Development of a written comprehensive supervisory plan for each joint examination, including:
 - An examination plan;
 - A risk assessment of the organization;
 - Results of prior examinations;
 - Review of organizational structure, internal control and compliance functions, and external audit; and
 - Review of pending issues, such as complaints, and compliance with enforcement actions or other regulatory requirements.
- A pledge by regulators to support one another, to the fullest possible and warranted, in the enforcement of laws that protect consumers of financial products and services. This collaboration includes:
 - Joint or coordinated investigations of wrongdoing and coordinated corrective actions; and
 - Consultation and information sharing regarding corrective actions.
- Development of processes, procedures, and protocols for uniformity and efficiency
- A protocol under which SPOCs will make every effort to resolve significant differences concerning the supervision of entities examined under the Framework, and will escalate to senior officials of the respective agencies where differences cannot be resolved

Additional information

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