

Reproduced with permission from BNA's Banking Report, 103 BBR 285, 7/29/14, 07/29/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

Liability

Managing Vendors In An Era Of Increased CFPB Scrutiny



BY BEN SAUL AND DAN ZYTNICK

For financial institutions, having compliance management systems that mitigate in-house risk is not sufficient to meet regulatory expectations. With more work now outsourced to third party vendors, financial institutions are facing heightened regulatory scrutiny of their vendors' actions and their oversight of vendors. Several recent consent orders between financial institutions and the Consumer Financial Protection Bureau spotlight the need for proper vendor oversight.

If the consent orders were not enough to highlight the need for vigilance, the CFPB's director emphasized recently that accountability for financial institutions requires holding them responsible for their vendors' conduct. Speaking to the Federal Reserve Bank of Chicago on May 9, 2014, Richard Cordray said "that companies

Ben Saul is a partner and Dan Zytlick is an associate in the Consumer Financial Services Litigation and Enforcement practice at the Washington, D.C., office of Goodwin Procter LLP. They represent lenders, servicers, and other clients in litigation and administrative enforcement actions concerning a broad range of consumer finance issues.

remain responsible for having an effective process for managing the risks of service provider relationships."¹

Financial institutions subject to consent orders may be required to increase their oversight of service providers. But for other financial institutions, doing so proactively by implementing effective vendor compliance systems can mitigate the risk associated with outsourcing to service providers.

Current Regulatory Landscape: Foreshadowing Enforcement Actions

Before the spate of recent consent orders, there was an April 2012 guidance bulletin issued by the CFPB entitled "Service Providers." In addition to describing its supervisory authority over service providers, the CFPB emphasized that the financial institutions it supervises cannot absolve themselves of responsibility for complying with federal consumer financial law by outsourcing functions to third parties.

The CFPB further stated that it expects supervised financial institutions to properly manage the risks of service providers. The supervised entities "should take steps to ensure that their business arrangements with service providers do not present unwarranted risks to consumers." The suggested steps include:

- conducting thorough due diligence to verify that the service provider can comply with federal consumer financial law;
- reviewing the service provider's policies, procedures, internal controls, and training materials to ensure that the provider conducts appropriate training and oversight of employees;

¹ Prepared Remarks of CFPB Director Richard Cordray at the Federal Reserve Bank of Chicago, <http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-federal-reserve-bank-of-chicago-2/>

- including in the contract with the service provider clear expectations about compliance, as well as proper and enforceable consequences for violating compliance-related responsibilities;

- establishing internal controls and ongoing monitoring to determine if the service provider is complying with federal consumer financial law;

- taking prompt action to address problems with the service provider.

The CFPB's Supervision and Examination Manual (Vol. 2, Oct. 2012) reiterates the CFPB's expectation that supervised entities "ensure that [service] providers effectively manage compliance with Federal consumer financial laws applicable to the product or service being provided." To this end, CFPB examiners look at whether supervised entities demonstrate "clear expectations about compliance, not only within the entity, but also to service providers." And CFPB examiners review policies and procedures "designed to ensure" that service providers comply with applicable legal obligations and that service providers who have customer contact or compliance responsibilities are appropriately trained.

The CFPB is not alone in emphasizing effective oversight of vendors. The Office of the Comptroller of the Currency ("OCC") and the Federal Reserve Board ("FRB") released similar guidance on third-party relationships in October 2013 and December 2013, respectively. Mirroring some of the CFPB's expectations, the OCC noted in its *Risk Management Guidance*, OCC Bulletin 2013-29 (Oct. 30, 2013) that banks should conduct due diligence on a third-party service provider's compliance with law and engage in a "robust analytical process" to identify, measure, monitor and control third-party risks. The FRB's *Guidance on Managing Outsourcing Risk* (Dec. 5, 2013) also stressed that the use of a service provider did not relieve a financial institution's board of directors and senior management from ensuring that the use of service providers were conducted in a safe-and-sound manner and in compliance with law; rather, according to the FRB, there is an affirmative responsibility "for ensuring that board-approved policies for the use of service providers are appropriately executed."

But it is the CFPB whose recent enforcement actions have highlighted the importance of managing vendors' compliance with federal law.

Enforcement Actions

The risks associated with vendors are apparent from several consent orders from the past two years. In those consent orders, the CFPB has alleged that financial institutions violated federal consumer financial law as a result of their vendors' actions and failed to effectively supervise vendors, and it has ordered remedial measures designed to increase the supervised institutions' responsibility for their vendors' actions.

The CFPB has asserted some supervised entities violated the law "through" their vendors' actions. Three months after issuing the bulletin on service providers, the CFPB entered into a consent order with Capital One Bank, N.A. relating to improper sales practices regarding credit card add-on products (99 BBR 159, 7/24/12). In that July 2012 consent order, the CFPB found that "representations of the Bank, through its [third-party]

call center representatives" were false or misleading and constitute deceptive acts or practices."

Similarly, in September 2013, the CFPB found that JPMorgan Chase, "through its vendors, engaged in unfair acts and practices" by accepting monthly payments from consumers for credit monitoring services that were not fully provided. Likewise, in December 2013, the CFPB concluded that American Express Bank and American Express Centurion Bank, "through [their] Service Providers, engaged in unfair acts and practices" by charging customers for products that the many of the customers were not fully receiving (102 BBR 11, 1/7/14). And in June 2014, the CFPB found that customer service representatives and third-party service providers for Synchrony Bank (formerly GE Capital Bank) improperly enrolled some credit cardholders in add-on products or misrepresented facts regarding add-on products (102 BBR 1197, 6/24/14).

As part of a consumer complaint monitoring process, maintain adequate records of complaints and inquiries received by service providers and the resolution of those complaints and inquiries.

The supervised entities were not on the hook solely for the violations committed by their service providers. The CFPB also found that the financial institutions engaged in ineffective oversight of the service providers. In the consent order with Capital One, the CFPB concluded that marketing deficiencies resulted from "ineffective oversight" of the service provider that "failed to prevent, identify, or correct the improper sales practices." In the 2013 consent order with the American Express banks, the CFPB attributed most of the alleged violations "to deficient management oversight" of service providers. That agreement followed October 2012 consent orders with American Express Bank and American Express Centurion Bank in which the CFPB found that each bank "failed to manage its compliance with Federal consumer financial laws and regulations adequately relating to . . . the Bank's oversight of affiliate and third-party service providers." In collecting consumer debt, the CFPB found that bank management "exercised ineffective oversight and control over the compliance function, particularly the oversight of" a service provider.

The remedial requirements set forth in the consent orders increased the supervised entities' responsibility for their vendors. For Capital One Bank, the consent order requires a written vendor management policy to be created and approved by the CFPB. Under the policy, as mandated by the consent order, before entering into a contract with a service provider, the bank must analyze whether the service provider can comply with applicable consumer protection laws. Contracts with service providers must specify the service providers' specific responsibilities and duties for maintaining adequate internal controls related to marketing, sales, delivery, and fulfillment of services for the bank's products. And the service providers are contractually obligated to provide adequate employee training on applicable consumer

protection laws. The consent order requires the contracts to grant the bank authority to conduct onsite reviews of the service providers and to terminate the contracts if the service providers materially fail to comply with the contractual terms. The consent orders with JP Morgan Chase and Synchrony Bank contained similar provisions. Notably, the requirements resemble the steps the CFPB advised supervised entities to take in its guidance bulletin regarding service providers.

Those are not the only terms that have ended up in consent orders. For instance, the 2012 American Express consent order required each bank to develop policies to “maintain effective monitoring, training, record-keeping and audit procedures to review each aspect of the Bank’s agreements with its Service Providers and the services performed for the Bank pursuant to these agreements.” The banks were also required to prepare quarterly reports detailing compliance issues with service providers, and the Board of Directors was deemed responsible for ensuring that “corrective actions” are taken.

The CFPB has emphasized compliance by service providers even in consent orders where it has not explicitly found violations by service providers or ineffective oversight of service providers. In its June 2013 consent order with U.S. Bank, N.A. regarding an automobile loan program for military service members, the CFPB required the bank to develop a compliance plan that ensures it and its service providers comply with federal consumer financial law, provides training for both its employees and Service Providers, and requires recordkeeping by service providers.

The FDIC has also entered into consent orders specifying how banks oversee vendors. A recent FDIC consent order required a bank to designate a compliance officer whose responsibilities include overseeing service providers and to develop and implement a third-party oversight program. Smaller banks are not immune. In March 2014, the FDIC entered a consent order with World’s Foremost Bank in Nebraska, which required the bank to “increase its oversight of any third party vendors that provide third party products or services which the Bank offers to its cardholders,” mitigate compliance risk by reviewing third-party product offerings, and require vendors to maintain sufficient documentation regarding third party product offerings. The FDIC entered into consent orders in 2013 with three banks in Illinois and Kentucky, which were required to review certain third-party vendors at least quarterly, and to conduct due diligence concerning vendors’ compliance before entering into new business relationships.

Prescription for Compliance

Despite the CFPB’s guidance bulletin on the subject, the agency has provided little insight into how supervised entities should monitor and regulate their rela-

tionships with service providers. Nevertheless, the CFPB’s various enforcement actions on the subject underscore some policies and procedures that supervised entities can implement to mitigate the risk associated with using vendors:

- Oversight and control of service providers should start at the top, with actively engaged boards of directors and senior management.
- Develop a strong compliance risk management program to monitor and detect compliance problems with service providers so that any such problems can be resolved.
- As part of a consumer complaint monitoring process, maintain adequate records of complaints and inquiries received by service providers and the resolution of those complaints and inquiries.
- Review and approve marketing and solicitation materials and other materials provided by service providers to consumers.
- Require service providers to provide prompt notification of regulatory inquiries, consumer complaints, and legal action related to their work for the supervised entities.
- Review risk management materials including policy manuals and procedures to determine compliance with federal and other consumer protection law and the supervised entities’ own procedures.
- Analyze service providers’ abilities to comply with federal consumer financial laws prior to entering into contracts.
- Specify in contracts each parties’ responsibilities with regard to compliance with the law.
- Conduct periodic onsite reviews of the service provider’s controls, performance and information systems.
- Utilize the internal audit function to ensure compliance with policies and procedures designed to mitigate service provider risk.

Some of these policy enhancements may require modifying contracts with service providers or changing practices before new contracts are ratified. But the enhancements, in addition to potentially leading to better relationships with customers served by service providers, may decrease the likelihood of regulatory enforcement resulting from ineffective oversight of, or unlawful conduct by, vendors.