Financial Services Regulatory Update

August 2017

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

Fair and Responsible Lending: Managing the Risk of Consumer Harm

Background

Banking regulatory agencies, applying rules and regulations according to Consumer Financial Protection Bureau (CFPB) oversight, have aligned their expectations for compliance with one another and with the rules. Simple enough: read the rules, develop processes and controls to manage compliance with the rules, test those processes and controls, and adjust as necessary. Section 1002(13) of the Dodd-Frank Act prescribes "fair, equitable, and non-discriminatory access to credit for consumers," but does not define "responsible lending." And what about *unwritten* rules? In addition to established Fair Lending laws, the agencies have published guidance related to the *2016 Interagency Consumer Compliance Rating System*, which articulate expectations for managing the risk of consumer harm, but the rating system is not directly or explicitly tied to specific federal regulations. Rather, they represent the *unwritten* rules banks and other financial institutions frequently struggle to manage in their development of compliance risk management processes and controls. The agencies have spent a good deal of time and energy on assessing whether the institutions they supervise offer and service credit products in a fair and responsible manner, even as they acknowledge prescriptions and prohibitions under federal regulations do not always neatly align with supervisory expectations.

The Latest in Enforcement Focus

One of the most common concerns raised during regulatory examinations is an act or practice regulators deem unfair, deceptive or abusive. The CFPB has issued guidance similar to that provided by the Federal Trade Commission when Regulation A provisions were introduced concerning unfair or deceptive financial products or practices. However, the guidance does not address whether products are inherently equitable or available to all creditworthy consumer customers – the *fairness* facet now making its way into regulatory exams.

In addition to this recent *fairness* focus within the context of consumer protection regulations, the regulatory agencies are also increasing attention on technical components of Fair Lending laws, such as redlining, discrimination in small business lending, and the manner in which consumer loans are serviced. Regulators are beginning exams in the current cycle by assessing the institution's compliance management system (CMS). Weaknesses in any of the three lines of defense, Board or management oversight, training, or compliance function staffing and expertise are likely to lead the exam team to expand transaction testing, scrutinize procedures and practices, and withhold a presumption of good faith on the institution's part if practices appear to increase the risk of consumer harm.

Among issues recently cited in regulatory exams (irrespective of which agency) are concerns that all relate to Fair and Responsible Lending:

- Lack of sales practices oversight leading to irresponsible product recommendations, offers or actual consumer harm through violations of consumer protection laws (e.g., Truth in Lending Act, Real Estate Settlement Procedures Act);

- Failure to fairly and adequately invest in the communities in which the institution has a presence;
- Failure to identify and serve the “credit invisible” – those who require or would benefit from alternative income, debt service or credit history documentation;
- Failure to appropriately delineate a *Reasonably Expected Market Area*;
- Limiting marketing and advertising in certain portions of the CRA Assessment Area;
- Limiting comparative review of Assessment Area performance according to too strict a definition of “peers”;
- Relying too heavily on the CRA program to manage Fair Lending risk (the programs are distinct but related);
- Failing to include deposit-related products and services (e.g., overdraft protection programs) in risk assessment; and
- Failing to test or otherwise assess the risk of disparate treatment of consumer applicants.

The bottom line for financial institutions is that an ounce of prevention in developing and implementing a solid CMS is worth far more than the pound of cure addressing practice weaknesses that likely would have been viewed as minor infractions had the CMS met regulatory expectations.

The Value of Creating the Narrative

At the heart of any compliance risk management program is the institution’s own statement of vision and mission. This statement, along with whatever follows from the statement, forms the institution’s Fair Lending narrative. Boards of directors dictate strategic objectives, which they authorize and empower executive and senior management to oversee. Management in turn delegates to staff the policies and procedures intended to match practices with strategic objectives and the formalized, documented expectations for those practices to meet regulatory requirements. When the organization has taken sufficient time and care to develop compliance risk management controls within the CMS to understand, test and confirm the alignment of strategic objectives and actual business practices across the institution, the results of testing and data analysis will confirm staff are meeting expectations, and that products and services are being offered, delivered and serviced in a manner consistent with regulatory expectations – not only for comply with regulations but also in reflecting the Board’s and management’s stated objectives. In other words, the Board has dictated a path toward certain objectives; management understand those objectives and what steps must be taken along the path; staff are adequately trained and equipped to walk along that path; and together, the organization has created its Fair Lending narrative.

However, in cases where the data analysis or testing results do not confirm expectations are being met, or worse, where testing and analysis are insufficient to recognize instances where the institution is not meeting strategic objectives, regulators will create the institution’s narrative based on their assessment of the CMS and the conduct of business according to rules, regulations, and the institution’s policies. Frequently, what results is a misunderstanding of the bank’s business or strategic objectives, a failure to understand or appreciate the reasons for the Board’s objectives, and an order or recommendation to adjust practices in a manner likely to be inconsistent with strategy. In other words, if the bank cannot tell its own story by effectively developing, implementing and testing its narrative, it may be unhappily surprised when its regulator suggests changes to the manner in which the bank does business, whether or not the suggestion makes sense given the bank’s strategic objectives.

Self-Assessment in Support of the Narrative

Compliance Officers across the country are well aware of the Interagency Fair Lending Examination Procedures. Good Compliance Officers understand how to translate the sometimes cryptic regulatory language into practical terms, paying attention to those *unwritten* rules, and enhance compliance risk management processes across the organization to meet regulatory expectations. The best Compliance Officers will do both, while keeping in mind the Board's strategic objectives and engaging in regular, frequent dialogue with the Board to keep them informed of developments or necessary adjustments based on regulatory, business or community changes.

Taking into account what their peers near from regulators, what the agencies communicate through guidance or during web conferences, and what they know of their own institutions, Compliance Officers have a unique opportunity to help the organization form and communicate its narrative, which is especially important from a Fair Lending perspective. The first step in defining, quantifying and communicating the narrative is gathering the data necessary to analyze the organization's actual business practices. Whether in the form of Home Mortgage Disclosure Act and Community Reinvestment Act loan application register data, core system reporting of loan originations (how many, how much, to whom and where), and reviews of consumer and small business denials, the data will demonstrate in very certain terms whether the bank's practical narrative – its practices – truly reflects the stated narrative.

More important than simply reading the narrative is shaping it: taking into consideration plans for growth, any limitations or advantages based on systems, processes, locations, and so on, resident expertise among management and staff, and weaving those facets together into a cohesive, deliberate action plan. Organizations with a well-defined, data-supported narrative fare far better in Fair Lending examinations than their less proactive, less informed counterparts.

How Experis can help

Experis Finance offers industry experience in all aspects of Financial Services, including:

- Performing Fair Lending, Compliance Management Program and Compliance Risk Management assessments
- Assessing the adequacy of your organization's compliance control environment
- Developing internal compliance monitoring and audit programs to address unique risks
- Developing data-based analysis and related Board reporting
- Evaluating processes and practices and developing program enhancements to address weaknesses

Our Risk Advisory Services practice can evaluate your compliance management program, provide comprehensive recommendations for improvement and help you address those recommendations.

Our team of professionals has extensive experience working with clients to address these issues to help them avoid costly fines and penalties. If you have any questions about or concerns around your implementation of these steps, contact an Experis representative at financialservicesindustry@experis.com or visit our website Experis Finance.