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MANAGING THIRD-PARTY COMPLIANCE RISK IN CONSUMER FINANCIAL SERVICES

In recent years, the CFPB and other regulators have brought a stream of enforcement actions against financial institutions relating to third-party compliance. The trend is likely to continue, given new rules and regulatory guidance, and the expansion of certain business models. The authors outline products and services that have been the focus of third-party scrutiny and then turn to the guidance issued by federal bank regulators and the CFPB on third-party oversight. They close with suggested best practices to ensure a robust third-party compliance management program.

By Darren M. Welch, Neepa K. Mehta, Anand S. Raman, and Joseph L. Barloon *

Vendors and service providers form an integral part of most financial institutions' operations. The use of third parties, if subject to appropriate risk management and oversight, can provide numerous advantages, including providing specialized expertise, facilitating greater penetration in the market, and allowing for a more efficient allocation of an institution's resources. However, as regulators have long warned, the use of third parties can present elevated consumer compliance and other risks, especially when such relationships are not subject to appropriate oversight and monitoring.

While the general concepts of third-party risk management are not new, recent developments have demonstrated that regulators view third-party relationships as one of the biggest sources of consumer compliance risk facing the consumer financial services industry today. The Consumer Financial Protection Bureau ("CFPB" or the "Bureau") and other regulators have imposed significant fines in enforcement actions where a service provider's conduct was at the heart of alleged violations relating to fair lending or unfair, deceptive, and abusive acts or practices ("UDAAP").

From July 2012 through the end of 2015, the CFPB initiated 48 enforcement actions relating to third-party compliance. These include enforcement actions against financial institutions alleging non-compliance by a third party or inadequate oversight of a third party, as well as actions against service providers themselves. Forty-two

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of the enforcement actions have resulted in settlements, for **$2.8 billion in consumer restitution (over $80 million per settlement on average)**, in addition to $246 million in civil penalties.

The Bureau's enforcement actions based on alleged third-party compliance issues have spanned the entire industry, including:

- indirect auto lending;
- debt collection and debt buying;
- payment processing;
- wholesale mortgage lending;
- mortgage servicing;
- ancillary products on credit card and auto loans;
- tax refund preparation;
- mobile phone billing;
- lead generation;
- credit reporting;
- merchant creditors;
- subprime credit cards;
- customer service vendors; and
- debt relief services.

In addition to this steady stream of enforcement actions, new regulations and the expansion of certain new business models will likely further increase the scrutiny of third-party relationships. For example, last October, CFPB Director Richard Cordray leveled criticism at technology vendors hired to help lenders comply with the TILA-RESPA Integrated Disclosure Rule, stating that these vendors had "performed poorly"and that regulators may need to focus on these vendors.[1] The reliance on systems technology vendors will be critical in the near future as new mortgage and small business data reporting initiatives – both of which will require extensive systems support and upgrades – are implemented. Moreover, with the fast rise of financial technology (or "FinTech") platforms and online marketplace lending models, bank regulators will likely focus on the significant third-party reliance issues that some of these platforms present.

Managing third-party risk is especially critical for providers of consumer financial products and services because these financial institutions can generally be held liable themselves for the practices of third parties acting on their behalf. This is particularly true in instances where consumers interact directly with the third party on a financial institution's behalf or the consumer cannot choose the third party that provides part of a consumer financial product or service. The roles of service providers are often highly integrated into an institution's business operations, and thus enforcement actions will often allege violations committed directly by both a financial institution and its service provider. Additionally, regulators have recently reaffirmed their intention to hold companies strictly liable for conduct of their agents pursuant to traditional principles of vicarious liability. For example, in October 2015, the U.S. Department of Housing and Urban Development ("HUD") proposed rules to formally codify third-party liability standards under the Fair Housing Act, including strict vicarious liability for acts of an institution's agents, as well as direct liability for negligently failing to correct and end discriminatory practices by those agents.[2]

This article discusses recent regulatory developments and compliance risks associated with third-party relationships. Section I discusses enforcement actions and other developments in a number of industry sectors where third-party compliance risks have been the subject of significant regulatory scrutiny. Section II summarizes recent updates to the third-party oversight guidance

[1] Prepared Remarks of CFPB Director Richard Cordray at the Mortgage Bankers Association Annual Convention (Oct. 19, 2015), http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-mortgage-bankers-association-annual-convention/.

[2] 80 Fed. Reg. 63,720 (Oct. 21, 2015).

provided by the bank regulatory agencies. Section III suggests best practices for financial institutions in order to reduce consumer compliance risk arising from third-party relationships.

I. ENFORCEMENT ACTIONS AND OTHER DEVELOPMENTS IN CONTEXTS THAT MAY GIVE RISE TO HEIGHTENED THIRD-PARTY RISK

This section highlights some of the products and services that have been the principal focus of third-party scrutiny, including (i) indirect automobile finance; (ii) ancillary products; (iii) mortgage brokers; (iv) correspondent and purchased loans; (v) mortgage servicing and REO; (vi) statistical models; (vii) marketing partnerships; and (viii) marketplace lending.

A. Indirect Automobile Finance

The CFPB has focused on indirect automobile finance as a top fair lending priority and has brought a number of recent enforcement actions. The indirect automobile lending model involves, by definition, a third-party arrangement because the finance company is a third party to the credit transaction negotiated directly between the automobile dealer and consumer. However, because regulators generally view the *finance company* as extending credit to the consumer, it is the finance company's policies – particularly their compensation policies – that have been the focus of regulators.

In March 2013, the Bureau issued a bulletin that outlined the agency's position that indirect auto lenders may be responsible for discriminatory pricing in violation of the Equal Credit Opportunity Act ("ECOA") and its implementing regulation, Regulation B, based on the legal theory of disparate impact.[3] In particular, the CFPB argued that financial incentives and dealer discretion in auto lenders' "markup and compensation" policies significantly increase the "risk of pricing disparities" based on race, national origin, and other prohibited bases. The CFPB also stated its view that indirect auto lenders can be "creditors" under ECOA and that the "standard practices" of indirect auto lenders "likely constitute participation in a credit decision" pursuant to ECOA and Regulation B.[4]

Since the issuance of the CFPB's bulletin, the Bureau and Department of Justice ("DOJ") have initiated public enforcement actions against several institutions, and the CFPB has reported that it has resolved other investigations through non-public, supervisory agreements.[5] In December 2013, the CFPB and DOJ entered into a consent order with Ally Financial Inc. and Ally Bank to settle allegations that Ally's policies resulted in a disparate impact in dealer markup disparities.[6] In the consent order, which was the CFPB's first major fair lending enforcement action, Ally agreed to pay $80 million to consumers and an $18 million civil penalty, monitor for disparities at the portfolio and dealer level, and provide remuneration to affected customers going forward. More recently, the CFPB and DOJ entered into consent orders with Toyota Motor Credit, American Honda Finance, and Fifth Third Bank in July and September 2015, respectively, that called for retrospective consumer remuneration and required the institutions to adopt systems with reduced dealer pricing discretion.[7]

There are complex and unsettled legal, jurisdictional, and methodological issues involved in the CFPB's efforts to regulate indirect auto finance and dealer compensation. And more recently, legislation has been advanced in an effort to repeal the CFPB's bulletin on indirect auto lending described above.[8] Nonetheless, the

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[3] CFPB, Bulletin 2013-02, Indirect Auto Lending and Compliance with the Equal Credit Opportunity Act (2013), http://files.consumerfinance.gov/f/201303_cfpb_march_-Auto-Finance-Bulletin.pdf.

[4] CFPB, Supervisory Highlights: Summer 2014, at 9 (2014), http://files.consumerfinance.gov/f/201409_cfpb_supervisory-highlights_auto-lending_summer-2014.pdf.

[5] *Id.* at 4.

[6] *Ally Fin. Inc.*, CFPB No. 2013-CFPB-0010 (Dec. 20, 2013).

[7] *Toyota Motor Credit Corp.*, CFPB No. 2016-CFPB-0002 (Feb. 2, 2016); *American Honda Fin. Corp.*, CFPB No. 2015-CFPB-0014 (July 14, 2015); *Fifth Third Bank*, CFPB No. 2015-CFPB-0024 (Sept. 28, 2015). The DOJ entered into a consent order with Evergreen Bank in May 2015 based on dealer markup on purchased motorcycle finance contracts. Consent Order, *United States v. Evergreen Bank Group*, No. 1:15-cv-04059 (N.D. Ill. May 7, 2015).

[8] The "Reforming CFPB Indirect Auto Financing Guidance Act" would declare CFPB Bulletin 2013-02 on indirect auto lending to "have no force or effect," require the CFPB to provide for a public notice and comment period prior to finalizing any guidance on indirect auto lending, make available publicly all studies, data, methodologies, and analyses relied upon for such guidance, and conduct a study on the costs and impacts of the guidance on consumers and women-owned and minority-owned

CFPB continues to aggressively enforce the fair lending laws with respect to dealer markup disparities through its supervisory and enforcement powers. Accordingly, indirect auto finance companies are well advised to review their dealer compensation and pricing discretion policies, and evaluate the effects of those policies on consumers.

B. Ancillary Products

Ancillary credit card products have been the subject of a number of CFPB enforcement actions, including its first enforcement action in July 2012 and more than a dozen since then. Common allegations are that banks and service providers have engaged in unfair and deceptive acts or practices in connection with the marketing and servicing of products such as debt cancellation agreements, credit reporting and monitoring, and identity theft protection and insurance.

Many of the allegations have focused on actions taken by service providers, as well as inadequate supervision of these service providers.[9] In one matter, typical of the cases in this area, the Bureau alleged that a bank's third-party call center representatives had deviated from call scripts and thereby misled consumers about product terms and conditions, and that these agents had engaged in misleading practices to prevent customers from cancelling their coverage.[10] In several of the cases, the CFPB alleged that the companies had unfairly charged consumers for certain credit monitoring services that were provided by vendors, but that the customers did not fully receive the services.[11] Most of the enforcement actions have been against the credit card banks and their affiliated entities, including service providers, though there have also been two actions against independent national service providers that marketed and fulfilled the products.[12]

In July 2012, the CFPB issued a bulletin regarding ancillary credit card products, which emphasized that institutions need to engage in "[o]versight of any affiliates or third-party service providers that perform marketing or other functions related to credit card add-on products so that these third-parties are held to the same standard, including audits, quality assurance reviews, training, and compensation structure."[13]

Automobile finance is another area where regulators have scrutinized ancillary products provided through third parties. For example, in June 2013, the CFPB entered into consent orders with U.S. Bank and one of its service providers regarding the alleged deceptive marketing of extended warranties and "GAP" insurance.[14] The CFPB alleged that the companies misled consumers regarding the cost of these products and the coverage of the extended warranties.

C. Mortgage Brokers

Over the last decade, one of the areas that has seen the most fair lending enforcement and class action litigation has been the wholesale mortgage lending industry. Under a wholesale mortgage model, mortgage lenders close loans originated by independent mortgage

footnote continued from previous page…

businesses. H.R. 1737, 114th Cong. (2015). The bill was passed by the U.S. House of Representatives on November 18, 2015 with support from both parties, but its prospects for passage in the Senate and enactment into law are unclear.

[9] *See, e.g., Citibank, N.A.*, CFPB No. 2015-CFPB-0015 (July 21, 2015) (agreement that bank would pay $700 million in consumer relief and a $35 million civil penalty, settling allegations that bank engaged in deceptive marketing, billing, and administration of debt protection and credit monitoring ancillary credit card products); *Discover Bank*, *Greenwood, Delaware*, FDIC Nos. FDIC-11-548b, FDIC-11-551k, CFPB No. 2012-CFPB-0005 (Sept. 24, 2012) (agreement that bank would pay $200 million to consumers and a $14 million civil penalty, settling allegations that the bank engaged in deceptive telemarketing and sales practices relating to ancillary credit card products); *Capital One Bank, (USA) N.A.*, CFPB No. 2012-CFPB-0001 (July 18, 2012) (agreement that bank would pay $140 million in payments to consumers and a $25 million civil penalty to the CFPB, settling allegations that the bank engaged in deceptive marketing practices relating to ancillary credit card products).

[10] *Capital One Bank, (USA) N.A.*, 3-6.

[11] *U.S. Bank Nat'l Assoc.,* CFPB No. 2014-CFPB-0013 (Sept. 25, 2014); *Bank of Am., N.A.,* CFPB No. 2014-CFPB-0004 (Apr. 9, 2014); *American Express Centurion Bank,* CFPB No. 2013-CFPB-0011 (Dec. 24, 2013); *JPMorgan Chase Bank, N.A.,* CFPB No. 2013-CFPB-0007 (Sept. 19, 2013).

[12] Stipulated Final J. and Order, *Consumer Fin. Prot. Bureau v. Affinion Grp. Holdings, Inc.,* No. 5:15-cv-01005 (D. Conn. July 1, 2015); Stipulated and Final J. and Order, *Consumer Fin. Prot. Bureau v. Intersections Inc.,* No. 1:15-cv-00835-LO-JFA (E.D. Va. July 1, 2015).

[13] CFPB, Bulletin 2012-06, Marketing of Credit Card Add-On Products (2012), http://files.consumerfinance.gov/f/201207_cfpb_bulletin_marketing_of_credit_card_addon_products.pdf.

[14] *U.S. Bank Nat'l Assoc.*, CFPB No. 2013-CFPB-0003 (June 26, 2013); *Dealers' Fin. Servs., LLC*, CFPB No. 2013-CFPB-0004 (June 25, 2013).

brokers, as opposed to the lender's own loan officers. Regulators and private litigants have brought enforcement actions and lawsuits alleging that lenders have failed to monitor and control discretionary broker pricing and product selection practices. In these cases, it has been alleged, under a disparate impact theory, that the lenders have violated ECOA due to pricing disparities disfavoring racial and ethnic minorities. Since 2010, there have been a number of DOJ and CFPB enforcement actions, as well as lawsuits filed by cities, against wholesale mortgage lenders under this theory.[15]

Most of the mortgage pricing fair lending enforcement actions to date have focused on conduct pre-dating April 2011, when regulations by the Federal Reserve on loan originator compensation first took effect. Those regulations, which were revamped by the CFPB after the Dodd-Frank Act, prohibited compensation to mortgage loan originators based on discretionary loan pricing or product steering by a broker based on a financial incentive to a product not in the consumer's interest.[16] While these changes in the law have reduced mortgage pricing fair lending risk, they have certainly not eliminated it entirely. For instance, in December 2015, the DOJ brought an enforcement action against Sage Bank in Massachusetts relating to disparities in revenue earned on retail mortgage loans to minority borrowers compared to that on mortgage loans to non-minority borrowers.[17] *Sage Bank* is notable as it is the first pricing discrimination enforcement action that has focused on loans made *after* the loan originator compensation rules took effect in 2011, and it demonstrates that regulators are continuing to focus on mortgage pricing discrimination issues.

Fair lending is not the only compliance risk associated with wholesale lending. Rather, other risks include UDAAP and related areas. These risks arise because mortgage brokers play a key role in marketing, discussing product benefits and terms with applicants and guiding their product choices, providing disclosures, completing applications, and gathering documentation in support of the loan applications. Accordingly, sound oversight of an institution's broker network is critical for mitigating UDAAP risk and managing other compliance requirements, in addition to fair lending.

D. Correspondent and Purchased Loans

As with indirect auto lending and wholesale mortgage lending, third-party origination issues can present fair lending risk in secondary market transactions. In *Adkins v. Morgan Stanley*, for example, the plaintiffs alleged that the policies and procedures of Morgan Stanley, which had purchased loans from subprime loan originator New Century Mortgage Company, had created a disparate impact on African-American borrowers, in violation of the Fair Housing Act (FHA), ECOA, and state law.[18] The court dismissed the ECOA claims as time-barred but allowed the FHA claims to proceed, holding that the plaintiffs' allegations were sufficient to state a claim of disparate impact discrimination. In doing so, the court noted that the FHA expressly applies to secondary market purchasing of mortgage loans, and emphasized allegations relating to Morgan Stanley's warehouse lending commitments, onsite due diligence of New Century loans, demand for loans with alleged "high-risk" features, and instructions to originate no-documentation loans when it appeared that the applicant could not afford the loan. The court concluded that the evidence was sufficient to support claims that Morgan Stanley's policies "set the terms and conditions on which it would purchase loans from New Century" and that these terms and conditions had resulted in a disparate impact when they caused New Century to issue toxic loans to the plaintiffs.

Likewise, in the case of *In re Johnson*, a Chapter 13 debtor alleged that a loan originator had targeted minority borrowers for predatory loans, and that the purchasers and assignees "were involved in this enterprise of selling toxic loans and targeting vulnerable minorities" because the loans were originated with securitization as the ultimate goal.[19] The court did not

[15] *See, e.g.*, Joint Mot. for Entry of Consent Order, *United States & Consumer Fin. Prot. Bureau v. Provident Funding Assocs., L.P.*, No. 3:15-cv-02373 (N.D. Cal. May 28, 2015); *Consumer Fin. Prot. Bureau & United States v. National City Bank*, No. 2:13-cv-01817 (W.D. Pa. Dec. 23, 2013); *United States v. Wells Fargo Bank, NA*, No. 1:12-cv-01150 (D.D.C. July 12, 2012); Consent Order, *United States v. Countrywide Fin. Corp.*, No. 2:11-cv-10540-PSG-AJW (C.D. Cal. Dec. 28, 2011); Consent Order, *United States v. AIG Fed. Sav. Bank,* No. 1:10-cv-00178-JJF (D. Del. Mar. 19, 2010); *City of Miami v. Bank of Am. Corp.*, No. 1:13-cv-24506-WPD, 2014 WL 3362348 (S.D. Fla. July 9, 2014), *aff'd in part, rev'd in part*, 800 F.3d 1262 (11th Cir. 2015).

[16] 12 C.F.R. § 1026.36(d), (e) (Regulation Z rules regarding loan originator compensation and steering incentives); 15 U.S.C. § 1639b(c) (Dodd-Frank Act mortgage anti-steering provisions).

[17] Proposed Consent Order, *United States v. Sage Bank*, No. 1:15-cv-13969 (D. Mass. Nov. 30, 2015).

[18] No. 12-cv-7667 (HB), 2013 WL 3835198 (S.D.N.Y. July 25, 2013).

[19] No. 09-49420, 2014 WL 4197001 (Bankr. E.D.N.Y. Aug. 22, 2014).

reject out of hand the proposition that a secondary market purchaser could be held liable under ECOA or the FHA, although it dismissed the complaints on the ground that the plaintiff had not alleged sufficient facts to support the claims.[20]

Fair lending scrutiny of mortgage loan investors can be expected to increase in the coming years as new Home Mortgage Disclosure Act ("HMDA") reporting requirements, finalized in October 2015, will provide greater insight into the role of investors in the loan origination process. For example, when the rule becomes effective in 2018, originators will be required to report Universal Loan Identifiers that will help regulators track the life cycle of a loan among HMDA-reporting institutions (including investors that report HMDA data).[21] In addition, originators will be required to identify the Automated Underwriting System ("AUS") and results thereof when the originator uses an AUS developed by a securitizer, federal government insurer, or federal government guarantor in the origination of the loan.[22]

Nor is fair lending risk the only risk associated with third-party originations. In November 2015, the Federal Deposit Insurance Corporation ("FDIC") issued guidance to supervised institutions regarding safety-and-soundness and consumer compliance risks associated with purchased loans and loan participations.[23] In its guidance, the FDIC cautioned that "over-reliance on lead institutions" has, in some instances, caused significant credit losses and contributed to bank failures, and that "it is evident that financial institutions have not thoroughly analyzed the potential risks arising from third-party arrangements." Accordingly, the FDIC advised institutions to underwrite and administer loan purchases "in the same diligent manner as if they were being directly originated by the purchasing institution," and to perform due diligence prior to entering (and periodically during the course of) third-party relationships. The FDIC stated that the due diligence should address, among other things, the third-party's compliance with consumer protection laws.

[20] *Johnson v. Wells Fargo Bank, N.A.*, No. 14-MC-1100 (RRM), 2015 U.S. Dist. LEXIS 28046 (E.D.N.Y. Mar. 6, 2015).

[21] Home Mortgage Disclosure (Regulation C), 80 Fed. Reg. 66,128-01, 66,174 (Oct. 28, 2015).

[22] *Id.* at 66,337.

[23] FDIC, FIL-49-2015, Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations (Nov. 6, 2015), https://www.fdic.gov/news/news/financial/2015/fil15049a.pdf.

E. Mortgage Servicing and REO

Following the 2008 financial crisis, regulators have increased their scrutiny of mortgage servicers and their management of third parties that handle loan modifications and foreclosures. In April 2011, for example, the Office of the Comptroller of the Currency ("OCC"), FDIC, Office of Thrift Supervision,[24] and Federal Reserve System ("Federal Reserve") took enforcement actions against 14 bank mortgage servicers for allegedly deficient practices.[25] And in February 2012, federal agencies and the attorneys general of 49 states entered into what is known as the National Mortgage Settlement with the five largest mortgage servicers.[26] This settlement – the largest consumer financial protection settlement ever – required more than $25 billion in financial relief to borrowers. On December 19, 2013, the CFPB and state attorneys general entered into a similar agreement with Ocwen, a large non-bank mortgage servicer.[27] Under that settlement, Ocwen agreed to fund $2 billion in principal reduction to eligible borrowers and refund $125 million to certain borrowers whose homes were foreclosed.

In these enforcement actions, the regulators alleged deficiencies in the management of vendors and other third parties, such as attorneys, that were involved in the foreclosure process. In particular, regulators alleged that servicers "generally did not properly structure, carefully conduct, or prudently manage their third-party vendor relationships with outside law firms and other third-party foreclosure services providers," resulting in "increased reputational, legal, and financial risks to the servicers."[28] Among the more sensational allegations was that servicers and their service providers engaged in "robo-signing" of affidavits and other documents in foreclosure

[24] On July 21, 2011, the Office of Thrift Supervision merged with the Office of the Comptroller of the Currency.

[25] For a summary of the review results, *see* Fed. Reserve Sys., OCC & Office of Thrift Supervision, Interagency Review of Foreclosure Policies and Practices (2011), http://www.federalreserve.gov/boarddocs/rptcongress/interagency_review_foreclosures_20110413.pdf.

[26] Press Release, DOJ, Federal Government and State Attorneys General Reach $25 Billion Agreement with Five Largest Mortgage Servicers to Address Mortgage Loan Servicing and Foreclosure Abuses (Feb. 9, 2012), http://www.justice.gov/opa/pr/2012/February/12-ag-186.html.

[27] Consent Judgment, *Consumer Fin. Prot. Bureau v. Ocwen Fin. Corp.,* No. 1:13-cv-02025-RMC (D.D.C. Feb. 26, 2014).

[28] Interagency Review, *supra* note 25, at 9.

proceedings without verifying the information – an allegation that received considerable media attention.

The CFPB has continued to be active in regulating mortgage servicing,and issued rules that took effect in 2014 to implement broad mortgage servicing reforms pursuant to provisions in the Dodd-Frank Act, covering topics such as enhanced periodic disclosures, lender-placed insurance, payment posting, and loss mitigation.[29]

The conduct of service providers has also been at the heart of a number of complaints regarding marketing of residential properties acquired by a lender or servicer after foreclosure, known as Real Estate Owned or "REO." Over the last several years, for example, the National Fair Housing Alliance ("NFHA") has filed complaints with HUD against eight banks or property maintenance vendors alleging that REO properties in non-minority areas were marketed and maintained materially better than REO properties in predominantly minority areas. One of the cases resulted in a public Conciliation Agreement.[30] Because the servicers regularly hire vendors to perform the maintenance and marketing of the properties, the complaints have focused directly on the servicers' vendor oversight and alleged failure to ensure that the vendors provide consistent services regardless of the racial or ethnic composition of the neighborhood.

F. Models Developed by Third Parties and "Big Data"

Banks and other financial institutions often rely on quantitative analysis and models in various aspects of their operations, such as loan underwriting and pricing decisions, measuring risk, and determining capital and reserve adequacy. These models are often provided by third parties with significant econometric and model-building expertise, and vast proprietary databases relied upon for building and validating the models. The implementation and use, model validation, and governance, policies, and controls relating to these models have been the subject of extensive bank regulatory guidance.[31]

The model risk management guidance notes the "unique challenges" associated with validating vendor and other third-party models where the modeling expertise is external to the bank user and some information that may be needed to validate the model is considered proprietary. Nonetheless, banks are expected to have an appropriate model risk management framework for both in-house and third-party models. And among the key components of model risk management is the concept of "effective challenge," *i.e.*, "critical analysis by objective, informed parties that can identify model limitations and assumptions, and produce appropriate changes."[32] Accomplishing effective challenge of models "depends on a combination of incentives, competence, and influence," and in some instances may call for assistance from a third party with the appropriate independence and expertise.

In November 2015, the FDIC updated its risk management guidance to express similar concerns regarding validation of third-party models. In particular, the FDIC's updated guidance states that whenever a bank relies on a third-party credit model for assessing credit risk, the bank should perform due diligence of the model, although the bank may rely on qualified and independent third parties to perform the model validation.[33]

Another significant source of potential third-party risk arises from the recent emergence of datasets and models marketed by data vendors derived from so-called "Big Data." The tremendous expansion of the digital environment and social media, coupled with advances in

[29] Mortgage Servicing Rules under the Real Estate Settlement Procedures Act (Regulation X), 78 Fed. Reg. 10,696 (Feb. 14, 2013) (12 C.F.R. Part 1024).

[30] Press Release, NFHA, National Fair Housing Alliance and Wells Fargo Announce Collaboration to Rebuild Homeownership Opportunities in 19 Cities (June 6, 2013), http://www.nationalfairhousing.org/Portals/33/NewsReleaseWellsFargoNFHA130606.pdf; U.S. Dep't of Hous. and Urban Dev., Conciliation Agreement, No. 09-12-0708-8, *Nat'l Fair Hous. All. & Wells Fargo Bank, N.A.*, (2013), http://portal.hud.gov/hudportal/documents/huddoc?id=hudvwfconciliation.pdf.

[31] Bd. of Governors of the Fed. Reserve Sys. & OCC, SR Letter 11-7, Supervisory Guidance on Model Risk Management (2011) ("Model Risk Management Supervisory Guidance"), http://www.federalreserve.gov/bankinforeg/srletters/sr1107a1.pdf; *see also* FDIC, FIL-49-2015, at 2 (if a purchasing institution relies on a third-party's credit models for credit decisions, the purchasing institution should "perform due diligence to assess the validity of the credit model"; institutions are not prohibited from relying on a qualified and independent third party to conduct the validation, but the institution must determine if the third-party validation is sufficient).

[32] Model Risk Management Supervisory Guidance 2.

[33] FDIC, FIL-49-2015, Advisory on Effective Risk Management Practices for Purchased Loans and Purchased Loan Participations (Nov. 6, 2015).

computing technology to handle the new data, have led to new business opportunities and innovative risk and marketing models. The competitive pressure to leverage this new data can be great, but with new technology comes new compliance risks, including transparency of proprietary models, compliance with the Fair Credit Reporting Act, possession (perhaps unknowingly) of data regarding race, ethnicity, and other prohibited bases, and potential disparate impact resulting from use of new data fields. Compounding the risks is the fact that there is minimal regulatory guidance regarding Big Data – though in the near future there may well be coordinated bank regulatory guidance along the lines of the interagency social media guidance issued in December 2013.[34]

G. Marketing Partnerships

In order to increase market penetration, providers of consumer financial services may choose to enter into marketing partnerships with other companies. These arrangements may create valuable opportunities, but as with any other third-party relationship, can present potential compliance issues. These risks are particularly significant in connection with mortgage products, in light of Section 8(a) of the Real Estate Settlement Procedures Act ("RESPA"), which prohibits kickbacks and referral fees in connection with mortgage settlement services.[35] In October 2015, the CFPB promulgated a bulletin regarding RESPA Compliance and Marketing Services Agreements, noting that the Bureau has identified RESPA violations in the form of Marketing Services Agreements ("MSAs") that "appear to . . . disguise kickbacks and referral fees."[36] The bulletin further observed that there are "steering incentives . . . inherent in many MSAs" that create elevated legal and regulatory risks, and described indicators of impermissible steering of business in connection with kickbacks and referral fees in CFPB investigations. In particular, the bulletin pointed to investigations identifying compensation arrangements based on the number of referrals generated and the revenue generated, increases in referral volume after the MSA was put in place, failure by one of the parties to perform promised services under an MSA (*e.g.,* underwriting, processing, closing, and title services), and failure to disclose to consumers referral arrangements with affiliates and that the consumer was free to shop around for the services provided by the affiliate. In response to the increased compliance risk reflected in the CFPB's bulletin and other recent CFPB activity, a number of mortgage industry participants announced that they are dissolving existing MSAs or refusing to enter into new MSAs.

Even outside the mortgage context, regulators have focused on consumer risks that can arise based on marketing agreements. For example, the CFPB has pressed for greater transparency in preferred lender arrangements between colleges and lenders,[37] and the OCC has criticized a bank's marketing of products and services at the locations of a payday lending and check cashing operation.[38] Based on these actions, it appears that when a third-party marketing partner interacts orally or in person with potential customers of a financial institution about the institution's product, managing UDAAP risk is particularly heightened.

H. Marketplace Lending and Other Third-Party Finance Models

Online "marketplace lending" has grown in less than a decade to $12 billion in originations to consumers and small businesses.[39] Such lending takes many forms, including peer-to-peer lending, and, more generally, any lender that "uses investment capital and data-driven online platforms to lend either directly or indirectly to small businesses and consumers."[40] The rise of online

[34] Fed. Fin. Insts. Examination Council, Social Media: Consumer Compliance Risk Management Guidance (2013), https://www.ffiec.gov/press/PDF/2013_Dec%20Final%20SMG%20attached%20to%2011Dec13%20press%20release.pdf.

[35] 12 U.S.C. § 2607(a).

[36] CFPB, Compliance Bulletin 2015-05, RESPA Compliance and Marketing Services Agreements 2 (2015), http://files.consumerfinance.gov/f/201510_cfpb_compliance-bulletin-2015-05-respa-compliance-and-marketing-services-agreements.pdf.

[37] Press Release, CFPB, CFPB Calls on Financial Institutions to Publicly Disclose Campus Financial Agreements (Dec. 17, 2013), http://www.consumerfinance.gov/newsroom/cfpb-calls-on-financial-institutions-to-publicly-disclose-campus-financial-agreements/.

[38] OCC, No. 2012-190, *Agreement By and Between Urban Trust Bank, Lake Mary, Fla. and the Comptroller of the Currency* 7 (2012), http://www.occ.gov/static/enforcement-actions/ea2012-190.pdf; Letter from Thomas J. Curry, Comptroller of the Currency, OCC, to Lauren K. Saunders, Managing Attorney, Nat'l Consumer Law Ctr., et al. (Aug. 23, 2012), http://www.nclc.org/images/pdf/high_cost_small_loans/letter-occ-check-smart-urban-trust-bank.pdf.

[39] Dep't of the Treasury, Public Input on Expanding Access to Credit through Online Marketplace Lending, 80 Fed. Reg. 42,866-01, 42,867 (July 20, 2015).

[40] *Id.*

marketplace lending is due to a number of factors, including advances in technology, expanded availability of data, consumer preferences for online and digital shopping, and a contraction in traditional bank lending. With the increase in activity has come an increase in scrutiny, including a July 2015 request for public input on marketplace lending from the Treasury Department.[41]

Some marketplace lending models are highly dependent on third-party relationships. For instance, in one common model, the marketplace lender is a non-bank entity that takes the application and engages in direct interaction with the consumer, while the creditor is a commercial bank that has an ongoing relationship with the marketing lender. The marketplace lender may then repurchase the loan from the bank after origination and service the loan. The marketplace lender's contractual relationship with the originating bank, and vice versa, must therefore be closely monitored.

One compliance risk that can be present in some marketplace lending and other business models is based on a "true creditor" argument. In some cases, regulators or plaintiffs have alleged that it is the non-bank entity that interacts with the customer – rather than the bank that extends the credit – that is the "true creditor" of the loan, and that the non-bank entity must therefore comply with state law. The case law addressing this argument is mixed and highly fact-specific.[42] A related argument is that federal banking law preemption of state law applies only to the bank itself and does not apply to a party that acquires the loan from the bank. There is case law going both ways on this issue, but a decision in May 2015 from the U.S. Court of Appeals for the Second Circuit – *Madden v. Midland Funding* – held that the preemptive effect of federal banking laws did not apply to a debt buyer that acquired delinquent credit card loans from a national bank.[43] The defendant in *Madden* is currently seeking review by the U.S. Supreme Court, and the long term impact and scope of the *Madden* decision remains to be seen.

II. BANK REGULATORY GUIDANCE ON THIRD-PARTY RELATIONSHIPS

A. OCC and Other Prudential Regulatory Guidance

Federal banking regulators such as the OCC and Federal Reserve have promulgated extensive guidance on third-party oversight and closely supervised such relationships, given the potential risks that these relationships can present for bank safety and soundness and for consumers. On October 30, 2013, the OCC substantially reworked its guidance for overseeing third-party relationships.[44] While the guidance applies only to OCC-regulated institutions, it is among the most comprehensive bank regulatory guidance on third-party risk management, and thus serves as a useful guide for all financial institutions.[45]

The updated guidance reflects a very different tone than the OCC's previous guidance on the subject, which dates back to 2001,[46] and indicates that the OCC believes that many banks have not adequately managed risk associated with the use of third parties. Thus, while the 2001 guidance stressed the use of third parties as being "a way to gain a competitive edge," "reduc[e] operating costs," and "boost[] fee income," the 2013 guidance omits such positive language, and instead

[41] Public Input on Expanding Access to Credit through Online Marketplace Lending, *supra* note 39.

[42] For example, *compare Sawyer v. Bill Me Later, Inc.*, 23 F. Supp. 3d 1359 (D. Utah 2014) (granting motion to dismiss class action alleging usury and other violations by payment processors who facilitated transactions with banks, even though it accepted as true allegation that non-bank attempted to evade state usury laws by partnering with bank) *and Hudson v. ACE Cash Express, Inc.*, No. IP 01–1336–C H/S, 2002 WL 1205060, at *4 (S.D. Ind. May 30, 2002) (federal law preempted usury claims despite accepting as true plaintiff's claims that a state-chartered bank played an "insignificant" role in a lending program that a non-bank had "designed for the sole purpose of circumventing Indiana usury law") *with CashCall, Inc. v. Morrisey*, No. 12–1274, 2014 WL 2404300, at *7 (W. Va. May 30, 2014) (affirming judgment in favor of Attorney General against CashCall for violating West Virginia Consumer Credit Protection Act, holding that CashCall – rather than its bank partner – was the "true lender" in the consumer loan transactions).

[43] *Madden v. Midland Funding, LLC*, 786 F.3d 246 (2d Cir. 2015), *petition for cert. filed* (U.S. Nov. 10, 2015) (No. 15-610).

[44] OCC, Bulletin No. 2013-29, Third-Party Relationships (2013), http://www.occ.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.

[45] The Board of Governors of the Federal Reserve System issued updated third-party oversight guidance addressing similar topics for supervised institutions in December 2013. SR 13-19/CA 13-21, Guidance on Managing Outsourcing Risk (2013), http://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf.

[46] OCC, Bulletin No. 2001-47, Third-Party Relationships (2001), http://www.occ.gov/static/news-issuances/bulletins/rescinded/bulletin-2001-47.pdf.

focuses on "concerns" about banks' third-party oversight practices, particularly that "the quality of risk management over third-party relationships may not be keeping pace with the level of risk and complexity" of the relationships.

The OCC's updated guidance addresses a number of issues, including the following:

Planning. The bank should develop a plan to manage the third-party relationship before entering into the relationship. This plan should include discussing risks inherent in the activity, outlining strategic purposes for entering into the third-party relationship, and obtaining board approval when critical activities are involved.[47]

Due diligence and third-party selection. During the due diligence process, the bank should consider, among other things, strategies and goals, legal and regulatory compliance, financial condition, and business experience and reputation.

Contract negotiations. Contracts should address not only the nature and scope of the arrangement, but performance metrics and benchmarks, the right to audit and require remediation, responsibilities for compliance with applicable laws and regulations, cost and compensation, indemnification, insurance, default and termination, and customer complaints.

Ongoing monitoring. Ongoing monitoring should address the quality and sustainability of the third-party's controls and compliance with legal and regulatory requirements. Other "key areas" for consideration include the "volume, nature, and trends of consumer complaints," and the third-party's "ability to appropriately remediate customer complaints."

Termination. Banks should ensure that relationships are terminated in an efficient manner. This includes developing a contingency plan to transition the services to another service provider, bring the activity in-house, or discontinue the activity.

Oversight and accountability. The bank's board, senior management, and employees who directly manage third-party relationships all have important roles in oversight and accountability.

[47] Critical activities include significant bank functions (such as payments, clearing, settlements, custody), significant shared services (such as information technology), and other activities that could result in significant bank risk or consumer impact.

Documentation and reporting. Banks should maintain proper documentation and internal reporting of their third-party risk management practices.

Independent reviews. Banks should conduct periodic independent reviews of the third-party risk management process to determine if the bank's processes align with its strategy and effectively manage risk.

The guidance also discusses the OCC's supervisory review authority regarding third-party relationships and notes that the OCC may "use its authority to examine the functions or operations performed by a third party on the bank's behalf." These examinations may address, among other things, "whether the third party engages in unfair or deceptive acts or practices."

In September 2014, the OCC also issued guidance regarding "heightened expectations" intended to strengthen the governance and risk management practices of larger OCC-regulated institutions, several of which address third-party risk management issues.[48] In particular, the OCC observed that institutions' risk governance frameworks should cover "risks associated with third-party relationships"[49] and that audit plans should "rate the risk presented by . . . activities that the covered bank may outsource to a third party."[50] These heightened standards apply to any insured national bank or insured federal savings association with average total consolidated assets of $50 billion or more, though the OCC has indicated that it may choose to apply the standards to certain institutions below that size as well.

B. CFPB Guidance and Dodd-Frank Act Liability

Like the OCC, the CFPB has focused on relationships with third parties. As noted at the outset of this article, the CFPB has brought several dozen enforcement actions across various segments of the consumer financial services industry. The CFPB's position on service provider oversight is expressed in examination guidelines, other Bureau statements, the Dodd-Frank Act itself, and these enforcement actions.

[48] Final Rule, OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 54,518 (Sept. 11, 2014).

[49] Proposed Rule, OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches, 79 Fed. Reg. 4282, 4283 (Jan. 27, 2014).

[50] 79 Fed. Reg. at 54,531.

One of the very first substantive bulletins promulgated by the CFPB related to third-party oversight, and expressed the CFPB's expectations on many of the same topics as the OCC guidance.[51] The CFPB bulletin states that, for example, providers of consumer financial services should: (i) conduct thorough due diligence to verify that the service provider understands and is capable of complying with federal consumer financial law; (ii) request and review the service provider's policies, procedures, internal controls, and training; (iii) include contract provisions regarding compliance expectations and enforcement; (iv) establish internal controls and ongoing monitoring to determine if the service provider is complying with consumer laws; and (v) promptly remediate non-compliance. Moreover, many provisions of the CFPB's Supervision and Examination Manual focus on third-party relationships.[52] For example, the Manual notes that CFPB examiners should "seek to determine whether the board and senior management have . . . [d]emonstrated clear expectations about compliance, not only within the entity, but also to service providers."[53] The Manual also states that examiners should request and review documents that demonstrate "that service providers who have consumer contact or compliance responsibilities are appropriately trained."[54]

The Dodd-Frank Act itself reflects congressional concerns regarding third parties and consumer compliance. For example, the UDAAP prohibition applies to "any covered person *or service provider*,"[55] and service providers to CFPB-supervised institutions are also subject to CFPB supervision.[56] In addition, one component of the "abusive" standard in the Dodd-Frank Act is if the conduct "takes unreasonable advantage of . . . the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service."[57] The CFPB has interpreted this prong to include situations where the consumer cannot choose a service provider or other third party selected by the provider of the consumer financial product or service, such as a mortgage servicer.[58] In effect, the CFPB has indicated that any use of third parties, where the consumer has no say in the selection of that third party, will be subject to increased consumer compliance scrutiny.

III. BEST PRACTICES

In light of the increasing enforcement focus on third-party oversight, banks, lenders, servicers, and other institutions may wish to re-examine their policies and procedures to ensure that they have a robust third-party compliance management program. With respect to consumer compliance in particular, issues to consider include the following:

- ***Due diligence.*** Financial institutions should conduct appropriate due diligence when selecting third-party service providers. The initial vetting process could include, as practicable, searching public information and conducting background checks on the third party and/or its principals, and inquiring about prior litigation and regulatory proceedings against the third party. In addition to the initial vetting, financial institutions could conduct periodic (*e.g.,* annual) reviews or re-certification of the third party.

- ***Contracts.*** Written agreements should specify compliance expectations and set in place mechanisms to monitor and enforce those expectations. In particular, contracts should have robust compliance-with-law provisions, and allow for auditing and inspection of the service provider. Contracts should also specify how the service provider will handle, respond to, and report consumer complaints.

- ***Review policies and procedures.*** Before entering into an agreement, institutions should review a service provider's policies and procedures, including compliance policies and procedures, to assess the strength of such controls.

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[51] CFPB, Bulletin No. 2012-03, Service Providers (2012), http://files.consumerfinance.gov/f/201204_cfpb_bulletin_service-providers.pdf.

[52] CFPB, Supervision and Examination Manual Version 2 (2012), http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

[53] *Id*. at Compliance Management Review 3.

[54] *Id*. at Compliance Management Review 8.

[55] 12 U.S.C. § 5536(a)(1) (emphasis added).

[56] *Id*. §§ 5514(e), 5515(d), 5516(e).

[57] *Id*. § 5531(d)(2)(B).

[58] *See, e.g.*, Richard Cordray, Director, Consumer Fin. Prot. Bureau, Prepared Remarks at a Consumer Advisory Board Meeting (Feb. 20, 2013) ("When people cannot 'vote with their feet,' their clout is limited, even though these products and services can have a profound influence on their lives."), http://www.consumerfinance.gov/newsroom/prepared-remarks-by-richard-cordray-at-a-consumer-advisory-board-meeting/.

- ***Compensation.*** Financial institutions should assess the UDAAP and fair lending risk related to their third-party compensation policies, as compensation tied to discretionary decision-making can present elevated fair lending risk. In the mortgage context, institutions should review third-party compensation policies to ensure compliance with the CFPB's loan originator compensation rules, as well as compliance with the RESPA Section 8 prohibition on kickbacks and unearned fees. And, across all industries, institutions should consider including quality- and compliance-based metrics as a component of compensation, such as in sales, underwriting, and customer service roles.

- ***Risk assessments.*** Financial institutions should consider conducting risk assessments of their third-party relationships and tailoring oversight practices accordingly. Factors that may give rise to heightened third-party risk include where the third party interacts directly with consumers, the institution's ability to control those consumer communications (*e.g.,* oral vs. written), and the potential for consumer harm based on conduct by a third party.

- ***Monitoring.*** Institutions should consider regular monitoring and oversight of vendors, including fair lending monitoring where appropriate. For example, indirect auto lenders should consider implementing a monitoring program that includes dealer-level and portfolio-level statistical monitoring, to the extent that auto dealers are afforded pricing discretion. Wholesale mortgage lenders should also consider monitoring at the broker and portfolio level for potential disparities on a prohibited basis. In addition to statistical monitoring, audits, mystery shopping, customer surveys, and other evaluations may also help financial institutions assess the performance of service providers.

- ***Training.*** Financial institutions should consider providing or making available compliance training for third parties, particularly those interacting directly with consumers. For example, institutions may require that third parties obtain training on compliance with the fair lending laws and UDAAP compliance. Likewise, banks may wish to provide fair housing training to companies that manage and market properties obtained through foreclosure.

- ***Remediation.*** Financial institutions should consider implementing remediation plans for oversight of third parties. For example, with respect to third-party originators involved in pricing contracts or loans, a fair lending remediation program could include steps such as counseling or training, increased scrutiny of contracts and loans, restrictions on discretion, or termination when unexplained disparities are identified. In some cases, consumer remuneration may be a component of the remediation plan as well.

IV. CONCLUSIONS AND LOOKING AHEAD

The appropriate use of third parties can be of significant value to providers of consumer financial products and enhance the quality of service to consumers. Relationships with third parties continue, however, to be one of the most significant sources of consumer compliance risk, particularly with respect to unfair, deceptive, and abusive acts and practices and fair lending. Consequently, it is more critical than ever for institutions to have robust third-party risk management practices. ■