

Getting Ready for a CFPB Examination: Lessons from the Recent Orders

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I – Background

On October 13, 2011, the Consumer Financial Protection Bureau (“CFPB”) published its Supervision and Examination Manual in furtherance of the responsibility given that agency by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The CFPB now has responsibility for the supervision and examination for compliance with a vast array of federal consumer protection laws.

The institutions subject to CFPB oversight and regulation include: banks with over \$10 billion in assets and non-bank financial businesses regardless of size in certain markets including: mortgage companies (originators, brokers, servicers and, loan modification and foreclosure relief services); payday lenders; private education lenders; and the larger participants in other markets including debt collection, consumer reporting, auto financing and money transmitters and remitters.

II – Regulatory Challenges

This new regulatory scheme presents *significant new challenges* to the above listed non-banking companies in several ways:

- Many of these companies have long experienced examination and regulation by state regulators *but not by Federal regulators*.
- The previous state supervision did not focus intensely on the protection of the consumer as the primary goal *but the CFPB will*.
- The combination of the CFPB’s rule-making and enforcement powers (and recent demonstrations of those powers) are unprecedented in their scope. They hold the potential for serious criticism of a non-bank financial company damaging its market reputation as well as forcing significant monetary penalties and restitution to its customers.

III – Recent CFPB Examinations

The CFPB’s evolving Supervision and Examination Manual and practices offer valuable insight into who will be examined, the procedures the CFPB will employ and the tools its examiners will use. Those companies facing CFPB examination, however, must necessarily experience some trepidation about what’s to come, how to conduct themselves during the exam and how to react when presented with the examination results.

The CFPB has been conducting examinations of the leading credit card banks (all of which exceed its \$10 billion in assets test). Three recent examinations (American Express, Capital One, and Discover) have resulted in widely publicized Consent Orders. The Consent Orders and related documents present CFPB’s findings concerning violations of law, failures of the compliance programs, criticisms of internal control and management and Board oversight and failure to supervise third party service providers. Each of the Orders emphasizes different aspects of the targets’ credit card programs. The specific conclusions of the CFPB (and other bank regulators

who joined the exams) focus on different issues. **But all result in enormous civil money penalties** assessed against the institutions, **near record levels of estimated restitution to customers** who the CFPB found were subject to the targets' compliance failures and, **major overhauls of the targets' compliance programs**, and finally, **oversight by the targets' Boards of Directors**.

The unique way the CFPB went about the examinations and the specific criticisms leveled against the three credit card banks are instructive for the upcoming non-bank examinations as well:

- CFPB senior examination staff has spoken about the fact that their new exam approach **opens the exam with CFPB enforcement staff** in the first and ongoing meetings with the target institutions. He explained that: "this way the enforcement people were ready to go with enforcement actions at the exam's conclusion." This differs from the familiar bank regulatory exam which did not posit that enforcement was needed until after the conclusions were reached. Perhaps, this stems from the CFPB's trolling for consumer complaints in its web research, on its web site, and through its mystery shopping teams prior to the actual exam.
- The CFPB specifically criticized and recommended specific corrective measures for the type, format, language and positioning of consumer disclosures and contract terms. The CFPB, in at least one Order requires the target to submit not only its new compliance program for a non-objection ruling by the CFPB but also must submit samples of the scripts, documents, agreements, and other material used by the target and its third party servicers in dealing with customers.
- All Orders require independent audit of the restitution by firms which have previously been approved by the CFPB. The targets must permit the sharing of auditor work papers and reports with the CFPB.
- All Orders require the more **hands-on involvement of the targets' Boards of Directors** in establishing and overseeing the performance of the newly reconstituted Compliance Program. In one case, the Board has to hire an independent firm to review monthly the compliance performance and report to the Board – which must take action on each item criticized in the report at its monthly meetings – and to the CFPB.
- All Orders continue in effect until released by the CFPB after a period of review of performance. **One Order stays in effect for 5 years by its terms**. Companies with regulatory Orders citing findings of violations of law typically have serious limits placed on their business activities, Boards have issues with liability insurance, Board members have concerns about the ability to discharge their other life roles, e.g., attorneys and CPAs might have state licensing issues, fiduciaries might be disqualified, even if the Order recognizes that the target and its Board did not agree to these regulator findings.

IV – Takeaways from This Pattern

There are four key implications of the CFPB's approach to date:

First, previous experiences with examinations, familiarity with regulators are not sufficient preparation for these new rigorous exams. There is a "new sheriff in town."

Second, no matter how ready you are, you will probably be found deficient of something. It's just a matter of how long or deep an examiner looks. It is instructive to probe the findings in the three exams mentioned above to see how relatively obscure some of the criticized practices were in the entire scheme of the companies' credit card programs.

Third, proactive and prospective compliance activities will necessarily be very expensive. Estimates by institutions and trade groups vary but all agree that compliance costs will dramatically increase. This is particularly due to the regulatory emphasis on directly involving the Boards of Directors. Boards can be individually assessed civil money penalties, become the subject of personal enforcement action and findings of breach of fiduciary duty. This obviously has Board members sensitized to the importance of compliance.

Fourth, existing methods of communicating with customers are being subjected to increased rigor and scrutiny with a new emphasis on the ability of the average consumer to understand what he/she needs to understand as the criterion for adequacy. This differs from the more traditional reliance on including exactly what the law requires in all disclosure situations and less concern about consumer awareness.

V – What to Do

Here are four steps you should take as soon as possible.

1. Get ready for the examination that's coming by conducting a self-awareness, examination readiness diagnostic exercise. Typically, this is done with an expert third party firm. Here, a firm that combines the regulatory acumen with deep subject matter knowledge is a key part of the team.
2. Familiarize your management and Board with the new and emerging examination process - the "hot buttons".
3. Understand how to conduct oneself during one of these examinations, how to relate to the examiners during and, how to deal with the regulators post-exam.
4. Brief the Board of Directors on the exam process, the possible (expected?) outcomes and alternatives and, the alternatives for dealing with the regulators post-exam.