Managing specialty finance compliance requirements with a compliance management system

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For over two years now, the Dodd-Frank Act and subsequent regulations issued by the Consumer Financial Protection Bureau (CFPB) have created a more complex regulatory environment and increased anxiety for specialty finance organizations.

Bulletins, the results of examinations and consent orders published by the CFPB have prioritized one key activity: the implementation of a method to manage a more complex compliance environment.

Now is the time to evaluate your organization's approach to managing compliance risk.

The bureau’s stance on compliance management systems

In the CFPB’s fall 2012 *Supervisory Highlights*, the bureau provided insight into its expectations for the specialty finance and financial institutions industries. The primary focus of the publication was the bureau’s expectation for a compliance management system (CMS) to exist at all organizations subject to compliance requirements. While the idea of a CMS is not new, the CFPB has elevated its expectations, and as a result, renewed the regulatory emphasis on the efficacy of compliance management approaches. According to *Supervisory Highlights*, “One of the most important responsibilities of the CFPB supervisory program is assessing the quality of the compliance management systems employed by the financial institutions under the CFPB’s jurisdiction.”

The CFPB’s *Supervisory and Examination Manual*[1] provides a solid foundation for an organization’s CMS. The four elements of an effective CMS, as outlined in the manual and detailed in this white paper, are:

- Board and management oversight
- Compliance program
  - Policies and procedures
  - Training
  - Monitoring and corrective action
- Response to consumer complaints
- Compliance audits

The CFPB expects specialty finance organizations to have a CMS that is appropriate for their respective size and complexity. A properly developed CMS will serve to mitigate the overwhelming regulatory risk in today’s unpredictable compliance environment. Regardless of your company’s size, and whether you have a mature CMS or are developing one for the first time, a deep understanding of the guidance and expectations provided by the CFPB is imperative.

To evaluate or build an effective CMS, an organization must identify and evaluate which consumer protection regulations pose the greatest risks. One of the best tools for determining how to scale a CMS is a risk assessment. Risk assessments can take many forms, and vary in complexity depending upon the organization. Development of a compliance risk assessment should cover all areas of a specialty finance company that are involved in activities governed by consumer protection regulations. A risk assessment should then provide an overall rating (i.e., high, moderate or low) of the risk to the organization, and should be used to build a CMS that mitigates the risks identified.

Board and management oversight

The first element of an effective CMS is board and senior management oversight. Oversight of compliance is critical, and like any other aspect of business, the tone and attitude towards compliance at the top sets cultural norms for the company. While regulators do not expect the board (or senior management) to have expertise in the technical aspects of regulations that impact the company it oversees, regulators do expect the board (and senior management) to have both a working knowledge of compliance risk faced by the organization and adequate resources devoted to managing risk.

The CFPB expects those with oversight responsibility at specialty finance companies to develop clear expectations about compliance, including setting clear policy statements, appointing qualified, experienced compliance professionals to oversee the compliance program, establishing compliance policies and procedures, allocating appropriate resources, addressing consumer compliance issues and risk through handling of consumer complaints and inquiries and developing audit schedules and coverage of compliance matters.[2]

Board and management oversight should focus on the company’s overall compliance, with attention to the highest risk areas. A specialty finance organization may take a variety of approaches to overseeing a CMS, depending upon the nature of the industry sector in which it operates, as well as its size and complexity.

The most common approach for CMS oversight is designating a compliance officer (or department) and housing the oversight function of the board in the audit committee, particularly since the committee will receive any internal monitoring or compliance audit results. Another approach is to instill a compliance committee within the board.

Good oversight and governance of compliance risks is dependent upon the adequacy of information provided to the board and senior management. Developing a monitoring process for the regulatory environment and adequately communicating results to the board and senior management is critical to the company’s ability to meet the CFPB’s expectations. For guidance on developing such a monitoring process, please reference RSM’s white paper, Why a compliance knowledge center is the best approach for addressing the Dodd-Frank regulatory deluge.

1 CFPB Supervisory and Examination Manual – October 2012, http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

2 CFPB Supervisory and Examination Manual – October 2012; Page 36

Developing a compliance program for your CMS

The second element to an effective CMS is a compliance program. A strong compliance program will implement controls and activities to mitigate or eliminate specific compliance risks faced by your organization. The CFPB and other regulatory agencies expect a compliance program to contain three controls and activities:

- Policies and procedures
- Training
- Monitoring and corrective action

These controls and activities, from an operational standpoint, are the most important aspects of a specialty finance organization's CMS, and guide the day-to-day functioning of the system. A formal, written compliance program should reflect the expectations and tone of senior management and the board. All regulatory agencies (not just the CFPB) expect a formal CMS to be in place.

Given the rapid rate of regulatory change, senior management and the board should ensure that the compliance program is reviewed and updated at least annually (or more frequently, as needed). Compliance program reviews should focus on a company's current and future products and practices to ensure it will meet the needs of the company. The compliance program should not be static, but rather dynamic, to address compliance risks as they arise. The three core elements of a compliance program should be integrated with one another to allow for an efficient and holistic response to addressing compliance risk.

Policies and procedures

Written policies and procedures are the first point of offense against potential compliance violations, not to mention one of the first places your regulators will look when evaluating the efficacy of a CMS. Written policies and procedures should cover training and monitoring activities related to a CMS, as well as consumer protection regulations specific to the services and products offered by your company.

The CFPB and other regulatory agencies will expect policies and procedures that align with your exposure to applicable consumer protection regulations. Policies and procedures should be designed to prevent violations, detect and prevent risk of harm to consumers, cover product and service life cycles and be maintained and modified to cover day-to-day employee activities.

One challenge associated with developing policies and procedures is that they must be perceived as an effective and usable tool by those who use them. It is an area where taking a shortcut is tempting, especially when resources are in high demand for other compliance management activities.

A common mistake is to take policies and procedures, such as those purchased from a third party or "borrowed" from another company, and put them into place. While efficient in the short run, such a practice will most likely not take into account your organization's unique compliance risk profile, exposing you to increased risk of noncompliance, and potentially rendering your policies or procedures useless. Staff, for whom the policies and procedures are intended to help, will not find the policies and procedures useful if they don't speak to their experiences, and aren't specifically designed for your specialty finance company's needs.

Moreover, inclusion of regulatory requirements in your policies and procedures over and above those that impact activities at your company results in larger than necessary manuals, additional burden for staff and criticism from regulators.

Another common misstep is to incorporate procedures into policies. This happens when application of a regulation related to job functions or areas of responsibility is included in a policy. Instead, regulatory policies should focus on general applicability and scope, while separate procedural documents should focus on applicability of regulatory requirements, as they relate to specific roles and responsibilities. Developing compliance procedures for specific areas of responsibility will allow for more transaction- or situation-specific applications to guide staff. This becomes particularly important when dealing with consumer regulations impacting all aspects of business operations (such as the Fair Debt Collection Act, Regulation Z, FCRA/FACTA, Fair Lending or UDAAP).

For example, a specialty finance lender could have the following related to Regulation Z:

- Regulation Z policy that applies to its lending activities of the company as a whole.
- Procedures which cover:
  - Origination activities
    - Disclosing and calculating APR and finance charges and fees charged by the company
  - Advertising activities
  - Servicing activities (as applicable)
    - Payment processing
    - Periodic billing statements
    - Billing errors and inquiries

Training

Next to establishing written policies and procedures, training is critical, as it is often the first in-depth exposure your staff will have with consumer compliance. The CFPB and other regulatory agencies expect specialty finance companies to have written training policies related to the roles of the board, management and staff. The expectation is for the training policy to address federal consumer protection regulations (with a focus on discriminatory and unfair, deceptive or abusive acts and practices). In the spirit of integration of the key elements of a compliance program, training should be aligned and consistent with established written policies, procedures and job functions.

The type of training will greatly depend upon the size and complexity of your company, but no matter what, training accompanied with well-written policies and procedures is your best control for mitigating the risk of noncompliance.

Documentation for training should be retained. Regulators expect to see documentation in support of topics covered and curriculum used in training, as well as evidence to support attendance. Just as important as the training documentation is written rationale for anything removed from the curriculum.

An effective training activity is to develop case studies specific to your organization's compliance or non-compliance experience. Case studies do not need to be elaborate, but can highlight common mistakes or misapplication of regulations. These can be developed from findings noted during monitoring activities, and allow for an opportunity to take theoretical trainings and apply them in practical and unique situations encountered at your own company.

Monitoring and corrective action

Each control and activity of an effective compliance program is equally important, but monitoring is the only one that allows for an assessment of the other two areas of a compliance program. Monitoring provides management with feedback on the effectiveness of policies, procedures and training.

In *Supervisory Highlights: Fall 2012*, the CFPB stated, "In a typical CMS examination, the CFPB evaluates both the understanding and application of the financial institutions' compliance management program by management and employees. The CFPB has found one or more situations in which financial institutions had articulated many elements of an appropriate compliance policy, but the policy was not followed." Recognizing and implementing effective monitoring processes will help identify shortcomings in your compliance program.

The CFPB expects compliance programs to include monitoring and corrective action. Developing schedules, appropriate scopes and corrective action taken for deficiencies identified by internal, external and regulatory examinations will help your organization satisfy this expectation.

Business unit management and the compliance officer or department must work together in developing a set of monitoring activities that help identify consumer compliance issues and potential trends. Coordination will ensure that monitoring activities are appropriately scoped and designed to provide relevant feedback on activities.

Monitoring activities can be conducted by business units, compliance staff or both. The key to effective monitoring activities is focusing on areas of highest risk. No company has the requisite resources to monitor all activities, and focusing on high risk potential (as documented in a risk assessment) should provide the most value. Key questions to consider when assessing monitoring activities include:

- Have there been any significant changes in staff or management overseeing areas of moderate to significant risk?
- Have new products, services, vendors or other business relationships been rolled out? If so, have there been changes in:
  - Software or programs used?
  - The portfolio or marketing focus?
  - Resource allocations?

Monitoring activities can take on many forms. One of the easiest methods is to incorporate monitoring into existing quality control activities. The key to incorporating compliance is ensuring that those performing quality control functions have an adequate knowledge of compliance (meaning an ability to apply the regulation to situations under review, and the ability to identify potential issues that may result in noncompliance) in the areas being monitored.

Many lending companies have implemented a second review of declined or withdrawn loan applications for possible approvals missed, and for any possible fair lending issues. This activity can be altered slightly and used to detect Equal Credit Opportunity issues. For example, an organization can take this review process and test the timing of the adverse action notices for compliance with the 30-day notice requirement.

A debt collection business can take existing processes for tracking recoveries made by collectors and look for trends that might indicate possible Fair Debt Collection Practices Act (FDCPA) issues. A collector or team whose recoveries jump significantly in a short period of time, as compared to their historical norms, might indicate a potential issue. Once this is identified, management can obtain an understanding for the increase to ensure that the collector or team is not conducting collection efforts in a manner that violates FDCPA.

A specialty lender may look at loan system reports used to track loans approved outside of policy limits (exception reports). While typically used to track policy exceptions, the report and process can be used to evaluate trends that could indicate Fair Lending issues. Such a trend might be an office consisting of predominately one ethnic or racial group receiving loans with policy exceptions approved at a higher rate than other offices or regions, with different ethnic or racial groups being represented.

Other monitoring activities may be more focused, such as a compliance self-assessment of a business unit or group. Self-assessments consist of interviews (with staff and management) and testing focused on a regulation or a specific aspect of a regulation. Results of a self-assessment should be reviewed and analyzed to gain insight into a business unit's or group's understanding and compliance with technical aspects of a regulation. The analysis should allow management to make a conclusion regarding the business unit's level of compliance with the regulation being assessed.

Transaction testing should also be integrated into self-assessments to validate responses provided. This process provides a great amount of feedback and information on the effectiveness of a compliance program, but monitoring activities should not be limited to this. In addition, the compliance department and staff should spend time interviewing and discussing practices. Interviews or questionnaires with open-ended questions can reveal a great deal about the staff's understanding and application of pertinent consumer regulations.

Information gathered from monitoring activities should be presented to the business unit, and, if conducted by someone outside the compliance department, to that department, as well. Significant issues or control deficiencies resulting in noncompliance should be elevated to senior management and the board (or board committee), as appropriate. Based upon monitoring activity findings, corrective action should be tracked, taken in a timely manner and routinely reported on.

Consumer complaint response

In the fallout of the mortgage crisis, heightened emphasis has been placed on the handling of consumer complaints. Complaint monitoring and its resolution is the third element of an effective CMS. It is imperative that processes are in place to ensure the company is "responsive and responsible in handling consumer complaints and inquiries," according to the CFPB.

Compliant response practices should:

- Be independent of any sales or service functions
- Have a system for tracking complaints, including data on:
  - Method of compliant (email, phone, letter, social media)
  - Date received
  - Communications with the person filing the complaint
  - Office location the complaint is about (if applicable)
  - Employee(s) involved (if applicable)
  - Date resolved
  - Nature of resolution and corrective action taken
- Include a complaint report to senior management and the board (or board committee)

The board and senior management should clearly articulate time frames for responding to initial complaints, conducting investigations, taking appropriate corrective action and communicating the resolution, or reason for no resolution, to the person filing the complaint.

Complaint management practices and tracking will depend upon the size and complexity of your company. For example, a small specialty lender might find it sufficient to designate a member of senior management (not responsible for origination or servicing activities) to oversee the handling and tracking of complaints, using a spreadsheet or simple database. A larger specialty lender may choose to have the complaint management practice housed with a compliance officer or department, while an even larger lender may choose to have multiple centers for taking complaints, and use more complex tools for tracking and analyzing them. If complaints are tracked at multiple locations, it is essential for the process to be consistent across all locations.

In addition, any complaint management process should feed into the company's monitoring activities. Complaint monitoring offers an avenue for catching Fair Debt Collection Practices, fair lending or UDAAP issues, without significant effort or testing. In addition, complaints should be reviewed to track repeat complaints, and as a result, changes in products, policies and procedures should be considered to alleviate the common complaints.

Compliance audit

Compliance audits are the fourth and final element of a CMS. Similar to monitoring activities, a compliance audit should be driven, in part, by your compliance risk assessment, with areas of moderate to high risk being the primary focus. Compliance audits are expected to identify any gaps in board policies and standards, and the scope should adjust accordingly, as the regulatory environment and the organization grows or changes.

While similar to monitoring activities in some ways, the CFPB distinguishes between monitoring activities and compliance audits. Compliance audits provide the board (or board committee) with a determination of whether risk management practices adopted by the board provide the desired level of compliance and consumer protection. Compliance audits are independent of the CMS and business function that includes sales or service.

Results from compliance audits are expected to be provided not only to the board, but also to members of senior management, business units and the compliance department. Audit reports should include a discussion of scope, time period reviewed, findings and recommendations and management's responses and corrective action.

Compliance audits, like monitoring activities, should feed information back into the compliance program and CMS loop.

Conclusion

The CFPB has clearly outlined what is expected from the specialty finance industry, in terms of a CMS. The expectations defined earlier provide companies under the oversight of the CFPB a guide for developing an effective CMS. On the surface, the CMS outlined by the CFPB appears to be geared towards large and complex companies. However, small- to medium-sized entities can meet the CFPB and other regulators' expectations by scaling the elements discussed above to the size and complexity of the entity. Scaling your CMS should be driven by a compliance risk assessment, providing insight into specific areas of high, moderate and low risk. By taking the information gathered from a risk assessment, management can focus appropriate resources with the right direction in developing policies and procedures, training and monitoring activities.

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