Board of Directors and Management Involvement in Consumer Compliance and Consumer Risk: The Shift in Emphasis from Consumer Compliance to Consumer Protection and the Re-Examination of the Compliance Management Program

October 15, 2012

Alan S. Kaplinsky, Practice Leader
Consumer Financial Services Group
Ballard Spahr LLP
215.864.8544
kaplinsky@ballardspahr.com

Michael S. Waldron, Practice Leader
Mortgage Banking Group
Ballard Spahr LLP
202.661.2234
waldronm@ballardspahr.com

Amy S. Matsuo, Principal
Financial Services Regulatory Risk
KPMG LLP
919.380.1509
amatsuo@kpmg.com

Christopher J. Willis, Partner
Consumer Financial Services Group
Ballard Spahr LLP
678.420.9436
willisc@ballardspahr.com

Copyright 2012 by Ballard Spahr LLP and KPMG LLP
## Upcoming Webinars

<table>
<thead>
<tr>
<th>Topic</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brave New World: The CFPB's Proposed Integrated Mortgage Loan Disclosures and Rules</td>
<td>October 18, 2012</td>
</tr>
<tr>
<td>Ballard Spahr's CFPB Election Scorecard</td>
<td>October 30, 2012</td>
</tr>
<tr>
<td>The Office of Minority &amp; Women Inclusion (OMWI) of the CFPB and Other Federal Agencies: <em>What It Is and How To Prepare for It</em></td>
<td>November 5, 2012</td>
</tr>
<tr>
<td>The CFPB’s Amicus Program</td>
<td>November 21, 2012</td>
</tr>
</tbody>
</table>

*For information or to register, visit [www.ballardspahr.com](http://www.ballardspahr.com) or e-mail questions@ballardspahr.com.*
Moderator – Alan S. Kaplinsky

• Practice Leader of the Consumer Financial Services Group at Ballard Spahr
• Devotes his practice to counseling financial institutions with respect to bank regulatory and transactional matters and defending them in individual and class action lawsuits (including CFPB investigations and government enforcement matters)
• First President of the American College of Consumer Financial Services Lawyers
• Former Chair of the American Bar Association Committee on Consumer Financial Services of the Business Law Section
• Co-Chair of the Practising Law Institute’s Annual Consumer Financial Services Institute, now on its 18th year
• Has been named as a tier one banking and consumer financial services lawyer in the 2006 through 2012 editions of Chambers USA
• Has been named in The Best Lawyers in America under financial services regulation law and banking and finance litigation from 2007 to 2013
• Recently named as the 2012 Philadelphia Lawyer of the Year for Litigation-Banking & Finance

Ballard Spahr LLP
Panelist – Amy S. Matsuo

• Principal in KPMG's Financial Services Regulatory practice
• Specializes in financial services regulatory project delivery, and program management of banking and non-traditional service provider regulatory compliance, enterprise risk management, and compliance risk
• Leads regulatory and consumer protection compliance assistance for diverse financial institutions, including major financial services companies, large mortgage servicers, mortgage lenders, and GSEs
• Frequent national presenter on consumer regulatory and the CFPB, as well as on enterprise-wide compliance programs, and responsible and fair lending practices
• Amy has worked on numerous CFPB-related engagements, including:
  • Managing the development and assessment of numerous enterprise-wide governance and compliance management programs for bank and non-bank financial service companies in preparation for or response to regulatory examinations and regulatory actions by the CFPB
  • Serving as the engagement lead for multiple fair lending program and statistical/analytic enhancements in advance of and in response to CFPB examinations and investigations
Panelist – Michael S. Waldron

• Practice Leader of the Mortgage Banking Group and a member of the Consumer Financial Services and Privacy and Data Security Groups

• Former in-house counsel for two national lender/servicing shops; draws on in-house experience to advise and represent mortgage companies, financial institutions, and secondary-market investors on the complexities of the current marketplace

• Leads on-site CFPB exam preparation strategy sessions for executive management/boards at mortgage industry clients

• Michael is an Editor of *Mortgage Finance Regulation Answer Book 2011-2012*, published by the Practising Law Institute.
Panelist – Christopher J. Willis

- Partner at Ballard Spahr and a member of the firm’s Consumer Financial Services and Mortgage Banking Groups
- Counsels financial institutions on regulatory matters, advises them on compliance with consumer financial services laws, and defends them in both individual and class action lawsuits, as well as governmental enforcement actions (including CFPB investigations)
- Chairs the firm’s Fair Lending Task Force
- Has been named in The Best Lawyers in America for banking and finance litigation and commercial litigation for 2013
- Frequent author and speaker on issues relating to consumer financial services regulation and litigation
In the financial services sector, regulatory compliance and risk management are nothing new. But in the aftermath of the financial crisis, what has changed is the laser focus on consumer protection and the close monitoring of conduct and customer treatment.

No industry segment is immune: retail banking, commercial and wholesale banking, investment banking, and insurance are, or will be, affected.

Today, new and newly empowered regulatory agencies are collectively contributing to heightened scrutiny on business practices all around the globe.

It’s No Longer Business As Usual!
Consumer Protection has become a top strategic and cultural driver and leading contributor to a company’s future success.

It has moved from Compliance and Risk to the C-Suite and Boardroom, with implications all across the enterprise.

The challenge is to reset corporate culture around conduct and compliance:

- Rethinking business models
- Designing and packaging new products
- Marketing through the right channels
- Pricing appropriately
- Reaching the right target
- Profit-making

“Consumer protection isn’t just the province of Compliance and Risk Officers – it’s the responsibility of the entire organization.”

Ballard Spahr LLP
Being “in compliance” is no longer sufficient. It is only the baseline for successful Consumer Protection initiatives in the new “Consumer Agenda” environment.

Issues Facing the Regulatory agencies:
- Staffing levels and skill sets
- Collaboration between prudential regulators
- Supervisory versus enforcement focus
- Difficulties gaining traction / political opposition
- Melding of many different skill sets / approaches
- Limitations of rulemaking authority
- Lack of accountability and transparency
- Complexity involved with managing confidential information

Regulatory agencies will focus on the ability to detect, prevent, and correct practices that present a significant risk of violating the law and causing consumer harm in such core areas as:
- Transparency, clarity, fairness of product and service offerings
- Complaint management
- Mortgage servicing
- Credit card lending
- Student lending
- Electronic fund transfers
- Payday lending
- Unfair, deceptive, or abusive acts or practices
- Third-party service providers
- Non-bank financial service providers
What board and management oversight will the CFPB be looking for?

• The CFPB believes strongly in "tone from the top" and evaluating an entity's "culture of compliance," and will expect the board to be keenly interested in receiving information and giving direction on consumer compliance issues.

• The board should require and review periodic compliance audits, receive regular and meaningful reports on compliance issues and complaints, and follow up on issues on a timely basis.

• The board should also receive training on consumer compliance issues, to place it in a position to evaluate and direct the company’s compliance efforts.
What board and management oversight documents will the CFPB expect to see?

- To evaluate board and management oversight, the documents the CFPB will expect to see include:
  - Records of the compliance training provided to the board
  - Written compliance policies
  - A formal compliance function document adopted by the board
  - Board minutes and records showing the chief compliance officer has independent access to the board and the board requests and receives compliance reports from management, follows up on potential problem areas, and directs corrective action where appropriate
The shift in focus from Compliance to Consumer Protection necessitates a re-examination of the Compliance Management System.

The “Three Lines of Defense” risk management model should be used as a foundation for designing the Compliance Management System. Below is a depiction of the overall risk controls roles and responsibilities for each line.

**FIRST Line of Defense: (Operations)**
- RISK CONTENT ACCOUNTABILITY
  - Key Roles/Responsibilities:
    - Manage risk, implement actions to manage and treat risk (including executing controls to mitigate risks)
    - Comply with risk management and control process
    - Implement risk management processes, where applicable
    - Execute risk assessments and identify emerging risks
- RISK PROCESS ACCOUNTABILITY
  - Key Roles/Responsibilities:
    - Establish policy and process for risk management and control activities
    - Provide guidance and coordination among all constituencies
    - Identify organizational trends, synergies, and opportunities for change
    - Initiate change, integration, operationalization of new events

**SECOND Line of Defense: (Standard Setters)**
- Risk Management
- Finance
- Technology (incl. Information Security)
- Compliance
- Legal
- Human Resources
- Communications
- Management Committees

**THIRD Line of Defense: (Assurance Provider)**
- Internal Audit
- Internal Audit
- Internal Audit
- Internal Audit
To address consumer protection imperatives across the business, the Board and C-Suite should consider examining the following key areas and questions:

- Is delivering consumer value included in all financial leadership discussions?

- Core Business Processes

- Customer Base

- Financial Performance Management

- Products & Markets

- Governance Control & Reporting

- Infrastructure, Data & Technology

- Staffing, Training & Development

- Leadership & Corporate Culture

- Incentives & Compensation

- BEHAVIORS & CULTURE

- FINANCIAL & BUSINESS STRATEGY

- INFRASTRUCURE & OPERATIONS

- Have you considered the impact of consumer protection on your business model, core processes, or infrastructure?

- What intelligence does your analysis of consumer complaints provide and how do you use it to drive better business practices or product improvements?

- What standards and data do you use to identify, analyze, and address consumer risks and potential consumer harm across every line of business?

- How quickly and decisively do you identify and address consumer issues?

- Is delivering consumer value a clear priority for the C-Suite and the board?

- Does your organization have a clear, consistent, and widely understood definition of consumer risk and consumer protection, and a process to assess the amount of consumer risk across the business?

- Do you have a clear understanding of the costs of remediation activities to your organization and the impact on capital and brand perception?

- Does your organization have a complete view of where consumer risk arises within your business and/or throughout the life cycle of your products and services?
What is at Stake for Directors?

- Consequences for the entity

- Definition of “related person” in DFA § 1002(25):
  “any director, officer, or employee charged with managerial responsibility for, or controlling shareholder of, or agent for, such covered person”

- A “related person” is deemed a “covered person” for all purposes under Title X – including the CFPB’s enforcement authority
## Key Areas of a Compliance Program

<table>
<thead>
<tr>
<th>Areas of a Compliance Program</th>
<th>Applicability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance and Culture</td>
<td>Unit responsibilities, Management Oversight and Accountability, a Compliance Strategy, and Positive Compliance Culture</td>
</tr>
<tr>
<td>Policies, Procedures, and Processes</td>
<td>Clarity and completeness of business unit/entity consumer policies with respect to key compliance and fair lending matters underpinned with procedures implemented in effective end-to-end processes</td>
</tr>
<tr>
<td>Risk Assessments</td>
<td>Business unit/entity compliance risk assessments that formally identify and assess applicable manual and automated controls (preventative and detective). Adequacy of data and regulatory data reporting of consumer protection and fair lending information and information systems and technology-related controls to address and help mitigate applicable consumer compliance requirements and expectations</td>
</tr>
<tr>
<td>Management Information, Data, and Data Reporting</td>
<td>Key performance indicators and reporting that provide valuable insights into compliance strengths and weaknesses enabling management information reporting and issue escalation, responsive actions, and continuous improvement</td>
</tr>
<tr>
<td>Monitoring and Testing</td>
<td>Business unit processes for the monitoring and testing of consumer compliance and fair lending regulations, as appropriate, to provide ongoing assessments of consumer compliance business unit performance</td>
</tr>
<tr>
<td>People</td>
<td>Skilled resources aligned to consumer compliance and fair lending requirements and expectations within the business unit/entity, and understanding and clarity of roles and responsibilities, performance measurement, and impact</td>
</tr>
<tr>
<td>Training</td>
<td>Awareness and formal training programs on consumer compliance and fair lending requirements and expectations, including whether job-specific and post-testing training has been developed and executed by the business unit/entity</td>
</tr>
</tbody>
</table>
Compliance Management: Another View

Compliance Management System

Oversight
- Define responsibilities of Board and compliance officer(s)
- Assess training deficiencies
- Assess compliance program deficiencies
- Review audit reports
- Monitor new lawsregs
- Monitor complaint trends
- Revise compliance program

Compliance Program
- Training
  - New employee
  - Refresher
  - Ad hoc (new lawsregs)
  - Testing
- Monitoring & Corrective Action
  - Test consumer loan files
  - Listen to calls
  - Discipline employees
  - Assess employee incentive compensation plans
- Policies & Procedures
  - UDAAP
  - ECOA
  - Military issues (SCRA)
  - FDCPA
  - Data security/document retention
  - Bankruptcy

Consumer Complaint Response
- Categorizing
- Tracking
- Resolving
- Reporting
- (Includes complaints lodged through any channel – customer service, FCRA dispute, BBB, regulator, etc.)

Compliance Audit
- Performed by non-operational staff or third parties
- Reports to management with follow-up and corrective action as needed

Ballard Spahr LLP
**Sample Compliance Roles (and their Relationships):**

<table>
<thead>
<tr>
<th>Role</th>
<th>Functions</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Board of Directors (BOD)</strong></td>
<td>Establish corporate goals and agree on the overall compliance policy and program. Assign responsibilities and define accountabilities.</td>
<td>This table provides key compliance roles by function. The yellow boxes depict key controls to facilitate meeting these roles.</td>
</tr>
<tr>
<td><strong>Senior Management Committee (SMC)</strong></td>
<td>Provide oversight and management-level governance on compliance management. Establish management focus and strategy. Review high-level monitoring of key compliance risks.</td>
<td>Audit Department acts as 3rd level of control</td>
</tr>
<tr>
<td><strong>Chief Risk Officer (CRO)</strong></td>
<td>Establish an integrated enterprise-wide risk management framework, including compliance. Assist in developing compliance strategy and provide leadership.</td>
<td>Legal Department is involved in advisory capacity</td>
</tr>
<tr>
<td><strong>Corporate Compliance (CC) &amp; Chief Compliance Officer (CCO)</strong></td>
<td>Establish an integrated enterprise-wide compliance risk framework. Establish compliance standards and execute policies. Identify new or changes to laws/regulations and serve as advisers regarding interpretations. Legal provides legal interpretations.</td>
<td></td>
</tr>
<tr>
<td><strong>LOB Compliance (LOBC) &amp; LOB Directors (LOBD)</strong></td>
<td>Establish, assess, test, and monitor compliance controls and performance. Accountable for compliance standards, and helping drive Operations compliance.</td>
<td></td>
</tr>
</tbody>
</table>
Overview of Current Regulatory Landscape

There have been attempts to reign in executive pay and tie bonuses into longer-term objectives.

However, bonuses still account for a significant proportion of the remuneration in large banks.

There is no legal enforcement of governance guidance, and rules are subject to local requirements.

There has been a plethora of enhanced governance guidelines from a range of regulators.

There are changes to the structure of supervision across the globe.

Supervision has become more intensive and more intrusive.

Reporting requirements are a constantly moving feat with significant data and technology costs for banks.

Establishment of the CFPB in the U.S.

Heightened prudential regulatory scrutiny.

Continued remediation and costs.

Basel 3 introduces two new liquidity ratios for banks.

High cost of adjustment for banks that rely heavily on short-term wholesale funding.

Force changes in business models and organizational structures.

Basel 3 introduces higher capital requirements for banks.

The rules are not being implemented uniformly on a global basis, giving rise to an unlevel playing field.

There are additional capital requirements for SIFIs.

Various regulatory initiatives are forcing banks to restructure with massive related costs.

Banks are starting to focus on core business activities.

Precise rules on derivatives trading are still to be finalized.

There is a possible conflict between EMIR and Dodd-Frank as both have third party rules.

Regulators are tackling financial crime in a more direct and proactive way.

Fines and large remediation projects are very costly for banks.
Questions/Resources

If you have questions about anything we covered today, please contact:

Alan S. Kaplinsky, Practice Leader  
Consumer Financial Services Group  
Ballard Spahr LLP  
215.864.8544  
kaplinsky@ballardspahr.com

Michael S. Waldron, Practice Leader  
Mortgage Banking Group  
Ballard Spahr LLP  
202.661.2234  
waldronm@ballardspahr.com

Amy S. Matsuo, Principal  
Financial Services Regulatory Risk  
KPMG LLP  
919.380.1509  
amatsuo@kpmg.com

Christopher J. Willis, Partner  
Consumer Financial Services Group  
Ballard Spahr LLP  
678.420.9436  
willisc@ballardspahr.com


Subscribe to the our e-alerts at www.ballardspahr.com (click “subscribe”).

Ballard Spahr