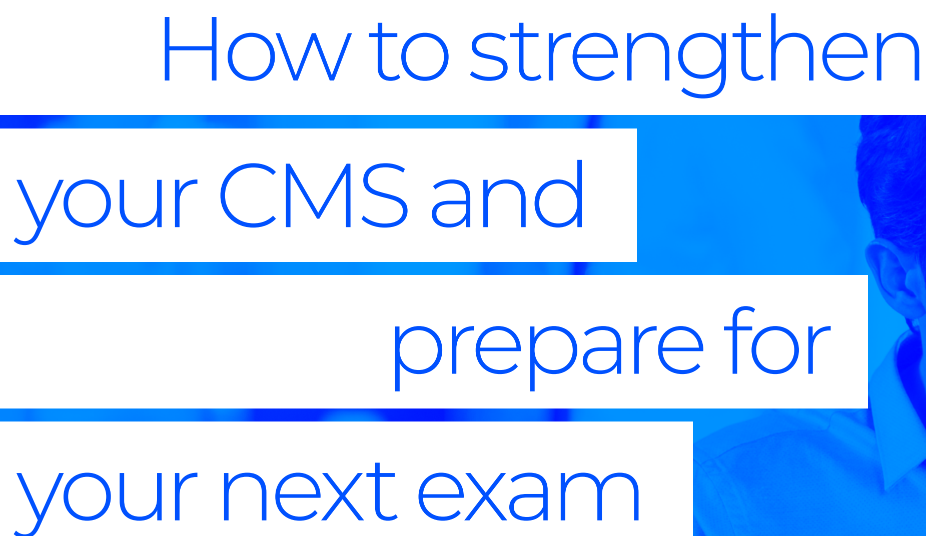

How to strengthen your CMS and prepare for your next exam

By Kathy Enbom and Kristen Eustis

Compliance management system (CMS) expectations continue to evolve. And because of this, it's important to remember why a successful exam matters to your financial institution.

Any formal or informal regulatory enforcement actions that come as a result of a negative exam also come with a high cost. At Wipfli, we've seen financial institutions try to save money by cutting back on compliance resources, only to end up spending that money two-fold if they end up with a regulatory enforcement action.

Then there's the risk to your reputation. When regulatory enforcement actions hit the newspaper or industry guides, your financial institution's reputation takes a big hit, and future success — along with job security — gets put at risk.

WIPFLI

Transitioning to the new standard

So, your CMS is important, but how do you prepare for your next exam?

The revised Uniform Interagency Consumer Compliance Rating System that went into effect March 31, 2017, made key changes to the framework used to evaluate compliance management systems. Because the standard takes a new approach to evaluation, understanding the changes made will help you obtain a successful result.

First, the standard changes the key focus to areas with the highest potential for consumer harm. It concentrates much less on the nitty-gritty details — likely a very welcome change for most financial institutions — and instead looks at the overall impact of regulatory violations on the consumer.

The new standard also helps ensure evaluations are comprehensive and consistent from institution to institution.

The rating scale

The exam results in an overall rating on a scale of 1-5, where 1 is good and 5 indicates that a financial institution has a critically deficient CMS and isn't adequately managing consumer compliance risk.

A key thing to note is that the exam has shifted from transaction testing to evaluating the sufficiency of your CMS and looking at your efforts to prevent consumer harm. The consumer is a big factor in the exam now. How well your financial institution serves and protects the consumer is critical. There's much greater emphasis now on your response to consumer complaints, which means your CMS must increase its emphasis on tracking and responding to consumer complaints.

But let's dive a little deeper into the exam.

The five-level rating scale

1. The highest rating of 1 applies to a financial institution that maintains a strong CMS and takes action to prevent violations of law and consumer harm.
2. A rating of 2 applies when a CMS is satisfactory at managing consumer compliance risk and at substantially limiting violations of law and consumer harm.
3. A rating of 3 applies when a CMS is deficient at managing consumer compliance risk and at limiting violations of law and consumer harm.
4. A rating of 4 applies when a CMS is *seriously* deficient at managing consumer compliance risk and/or at preventing violations of law and consumer harm. It shows fundamental weaknesses in critical CMS elements and core compliance areas.
5. A rating of 5 applies when a CMS is *critically* deficient at managing consumer compliance risk and/or at preventing violations of law and consumer harm. It shows an absence of crucial CMS elements and a lack of willingness or capability to take the steps necessary to prevent consumer harm.

The four principles

The exam adheres to four main principles. Each exam is:

- Risk-based
- Transparent
- Actionable
- Compliance-incentive

1. Risk-based

Agencies have recognized that a CMS should vary based on the financial institution. Because the rating system is designed to ensure your CMS is commensurate with your size, complexity and risk profile, it's important to understand your risks.

And this is where financial institutions can help themselves. We know some small community institutions sometimes feel like the examiner is treating them like a large, national organization. But they're making general risk assumptions because they don't know your specific risks. If you can communicate your actual risk profile to them, you can prevent these more sweeping assumptions.

2. Transparent

Examiners are trying to be more transparent and consistent across agencies and financial institutions.

3. Actionable

The emphasis here is on identifying areas of strength within your CMS and paying direct attention to areas of weakness and how they can be improved.

4. Compliance-incentive

The new CMS rating system actually incents compliance, especially the proactive identification and rectification of compliance issues. Some financial institutions are hesitant to tell an examiner about issues they've had, but having identified and solved issues actually demonstrates the strength of your CMS. Examiners want to see that you have a strong program that can identify issues, and that you will take immediate steps to solve those issues.

The three categories of the CMS rating system

You know the rating scale. You know the foundational principles of the rating system. But what are examiners actually going to be looking at? To give you a full view of the CMS rating system, we're going to dive into its top three categories:

- Board and management oversight
- Compliance program
- Violations of law and consumer harm

1. Board and management oversight

Do you have a culture of compliance in your organization? Examiners will look to see how committed your board of directors and senior management team are to creating or sustaining this culture.

But, perhaps more importantly, examiners will also look at change management. This is one of the things we at Wipfli see examiners pay a lot of attention to. They want to know that your financial institution supports a timely and satisfactory response to any internal or external change. Types of change include regulations, products and services, staffing, technology and more.

Examiners are looking for evidence that you planned for a change. Did you hold trainings? Assess the risk of the change? Implement policies and procedures? Conduct testing on the change after implementation?

They ultimately want to know that your board and senior management have assessed the risks inherent in the products and services you offer and that you've self-identified and taken corrective action on any issues.

2. Compliance program

Here, we're touching on four main areas: 1) policies and procedures, 2) training, 3) monitoring and audit programs and 4) consumer complaints.

Are your policies and procedures appropriate to the risk-level of your products and services?

Is your training program current and tailored to your risks and your staff? If you use online training programs, you should make sure they're tailored to your organization and each individual's job responsibilities, or supplement the online training with customized internal training.

For monitoring and audit programs, it's all about risk. This is a good opportunity to demonstrate what your risks are and tailor your monitoring and audit programs to encompasses these risks. There should be a higher level of monitoring and audit in these higher-risk areas.

And then there are consumer complaints. We briefly touched on how you should be tracking and resolving consumer complaints, but we can't emphasize enough that examiners will be looking at the responsiveness and effectiveness of your consumer complaint resolution process.

Often, when Wipfli interviews financial institution staff, asking about consumer complaints, we find that staff believe they haven't had any consumer complaints. But in reality, consumer complaints aren't being adequately compiled and addressed. Your staff must understand what's a consumer complaint and requires follow-up. You may think it looks good if you don't have complaints, but if an examiner walks into your lobby and asks your tellers if they get complaints from consumers, your tellers certainly aren't going to say their customers never complain about anything.

What you should be tracking does depend on the situation. If a customer is complaining that your loan rates are too high and your deposit rates are too low, that's not something you need to track.

But what about if you have a customer complaining about a service charge that they didn't realize they were going to be hit with? You can probably easily point to a disclosure and technically resolve the complaint. But if you're tracking complaints — and this is especially true if you have multiple branches — you may find that multiple customers have made the same complaint. Then you know there's a systemic issue. Maybe customers don't understand the disclosure. Maybe staff members aren't properly explaining it to them from the beginning. Or maybe they aren't even receiving the disclosure.

So what may feel like a single complaint might be more widespread than you think, and so they are worth tracking and analyzing.

3. Violations of law and consumer harm

The last category looks at root causes of violations of consumer law due to weakness in one or more elements of your CMS. Did a regulatory violation cause consumer harm? Or did it weaken the CMS? How did the violation occur?

Even if the violation doesn't cause consumer harm, it does indicate a weakness in your CMS. Perhaps your training or your policies and procedures are not strong enough to sustain your CMS.

Examiners also care about the severity of consumer harm caused by the violation.

For consumers, it's not just about fees. It's also about the denial of opportunity. If something was explained in a disclosure or advertising in a way that caused the consumer to interpret it as not being applicable to them, but if it had been explained in a different way, the consumer might have realized it was beneficial for them — that's an example of denial of opportunity.

So it's important to understand what regulatory violations will cause consumer harm and what the severity would be. Duration and pervasiveness matter here, too. The longer a violation goes on, the more supervisory concern will be applied to it. And how widespread a violation is, the more scrutiny you will see (and it will be reflected in your compliance ratings).

An important thing to note here is that third-party relationships are evaluated as if their services are provided by you directly. While you can outsource operational aspects of a product or service, you can't outsource compliance with regulations. Third-party risk management is key, and it extends to compliance exams.

Your rating

The relationship between a satisfactory rating and law violations isn't as stark as you might think.

You can still get a less than satisfactory rating without having violated any laws. That's because if there are weaknesses in your CMS that were identified but left unaddressed, they could result in future consumer harm or regulatory violations. If your policies and procedures, monitoring or other aspects of your CMS could lead to violations of law or consumer harm, examiners want to see that those issues have been addressed.

Which leads to our next point: A satisfactory rating could be assigned even when violations of law were cited. These violations must be self-identified, resolved promptly and have a limited impact on consumers.

So self-identifying issues and reimbursing consumers when appropriate can be beneficial. The examiner will ultimately arrive at a consumer compliance rating that reflects your CMS's effectiveness, so to see that it has caught issues (and that you've resolved them in a timely manner) is a good thing. Don't be hesitant to share the issues you've caught with your examiners.

For tracking these issues, something as easy as a spreadsheet may be adequate. A spreadsheet can help you track what the issue is, how and when it was identified, how and when it was resolved, and identify how many consumers were impacted.

We also recommend some of these issues go through your compliance committee (if you have one) because they can then be tracked in your compliance committee minutes, which often are shared with examiners.

Hot topics

Lastly, we're going to highlight nine areas examiners are focusing on. This comes from exams we're involved with, regulatory agency reports and other reports we see.

1. Flood insurance

Make sure your determination is pulled prior to closing and allows the borrower sufficient time to get flood insurance if it's required.

If you are reusing a flood determination, make sure it was obtained within the last seven years and there has not been a map change. Also, while a determination can be reused, the notification form must be provided for each MIRE (making, increasing, renewing or extending the loan) event when the property is located in a special flood hazard area.

You will want to ensure the policy is written for the same zone as the determination, so check this with every renewal too.

As for private flood insurance, new acceptance rules went into effect on July 1, 2019. You will need to look for the compliance aide statement or see if it meets the criteria within the discretionary acceptance provisions.

We also need to discuss escrow requirements. For all loans secured by residential improved real estate or a mobile home that experience a MIRE event after January 1, 2016, the lender must escrow all flood insurance premiums — subject to certain exceptions. If, as of July 6, 2012 (date of enactment of the Biggert-Waters Act), the institution had total assets of less than $1 billion and did not have a policy of consistently and uniformly requiring the escrow of taxes, insurance, fees or other charges, they are exempt from the escrow requirement.

However, this requiring of escrow does not just apply to portfolio loans. If the institution originated and sold loans to investors and retained the servicing rights, and the investor had a policy of consistently and uniformly requiring escrow, then the institution would not be eligible for the exemption.

Lastly, for detached properties, the detached structure exemption became effective upon the enactment of the Homeowner Flood Insurance Affordability Act (HFIAA) on March 21, 2014. There are four things you need to consider before exempting detached properties:

- Is it part of a residential property?
- Is it used primarily for personal, family or household purposes?
- Is the structure fully detached? For example, make sure it's not connected by covered breezeway or a deck connecting the two structures.
- Can it serve as a residence even if not currently being used for that? If so, it may not be exempted.

2. ARM Rate Adjustments

Following the ARM rate adjustment notice requirements can be tricky. Whether you are generating the 60 to 120 day notices, or the 210 to 240 day notices, be sure the notice is actually being sent 60-120 days, or 210-240 days, before the date of the first payment at the adjusted level and not the given number of days before the date of the rate change.

Also, you may want to consider using something between 60 and 120 or 210 and 240 days to account for circumstances when, for example, the 60th or 210th day falls on a Saturday, Sunday or holiday Monday. In these cases, your core system may generate the notice on the prior Friday, which is less than the required number of days and could change the value of the index used, as well as the resulting interest rate.

Speaking of the index, be sure that the description of the index being used is correct and matches the promissory note. Sometimes the notice has character number restrictions, which makes it difficult to use the full name of the index. Find an abbreviation that still makes it possible to identify the index. Additionally, ensure the location for researching information on the index provided on the ARM notice is the correct one. Website addresses sometimes change, so be sure the address being used is current.

For the lookback period, sometimes agreements have shown a lookback period for the index date used for rate adjustments, and sometimes they have not. These differences, often caused by changes in loan document providers, have tripped up many financial institutions that treat all adjustable rate mortgage loan rate changes the same. If your financial institution changes document providers, you must ensure that the new document contains the same lookback period as the prior loans you originated, or that you appropriately onboard the loan in the mortgage servicing system.

3. Overdrafts

For programs that automatically transfer funds from one account to another to cover an overdraft, how is your system handling a transfer account (a savings account, or overdraft line of credit, for example) that does not have enough funds to cover the overdraft? Is it transferring the balance in the transfer account, charging a transfer fee and then also charging overdraft fees on the remaining items in the checking account?

We are hearing examiners take the stance that this is unfair to the consumer, since the institution is collecting both the transfer fees and an overdraft, or multiple overdraft fees.

The flip side of the argument is that a partial transfer could save the consumer money by covering some of the overdrafts with the small transfer fee and only charging an overdraft fee for the few remaining items. Financial institutions should understand how the overdraft transfer account is working and ensure that your agreement is clear to the consumer.

If you find that your existing agreement isn't completely clear about your practices, consider a change of terms or clarification to existing customers so everyone understands how your product works. For new transfer agreements, ensure the language clearly describes the program. Some document providers have recently enhanced their forms with language that is clearer, so be sure to check there for new language. And, if your review of the program reveals that a consumer has been harmed by the unclear language, you should consider whether it warrants a rebate of fees.

4. HMDA

The regulatory agencies indicated in 2018 that they weren't going to issue Civil Money Penalties (CMPs) for inaccurate reporting of HMDA data as long as institutions made a good faith effort to comply with the new reporting requirements. But now that we are into the 2019 HMDA data collection season, institutions should review procedures to ensure accurate reporting of info.

This is a great example of the change management the examiners are talking about. When you implemented the HMDA revisions in your organization, did you provide training to staff? Did you implement new procedures? Did you test to make sure your systems are working appropriately?

In 2019, there will be a higher level of accuracy expected. Look at how your 2018 submission went and determine if any strengthening needs to occur with your HMDA LAR creation processes.

5. TRID

As mentioned, examiners are continuing to look at consumer harm. Are there systemic issues regarding disclosures under TRID that have not been corrected? Examiners are continuing to look at tolerance issues and APR violations.

Make sure that if fees are increased beyond the allowed tolerance, there is a valid change in circumstance and supporting documentation. If not, you will want to ensure there are procedures in place for prompt tolerance cures.

This is an area where we see clients — when they're preparing for a regulatory exam — call us and ask if they should really tell examiners about tolerance cures. The answer is yes — this demonstrates a good CMS that seeks to identify and resolve instances of consumer harm.

Examiners want to know you're watching your loans, determining if fees have increased, and curing those with your customers when appropriate. They want to see that you've taken appropriate steps to reimburse fees to customers, no matter when you identified them.

6. Military Lending Act

Two things are important here. The first is to ensure the covered borrower status check is done in the proper timeframe:

- When the consumer initiates the transaction or 30 days prior
- When the consumer applies for a covered loan or 30 days prior
- When the creditor develops or processes a firm offer of credit so long as the consumer responds to the offer within 60 days

We've seen some institutions that perform covered borrower checks via a credit report from a credit reporting agency, rely on a credit report that was obtained a couple of months or more prior to the new credit request. If the credit report is older than 30 days, you will need to perform a new search on the Department of Defense website or obtain a new credit report (but also keep in mind Fair Credit Reporting Act requirements relative to use of credit reports for the original purpose intended).

The second important thing to note is that on June 27, 2019, the Military Lending Act website enhanced security to their site. A user account is now required to access both the single record request and the multiple record requests. No searches will be possible without an account, so if you are conducting your searches through the Department of Defense website, you will need to get a user account established.

Also, since this is a newer regulation, if you have not yet been examined for compliance with the Act, you will want to show how you prepared for compliance with the new rules.

7. Mortgage Servicing

We've broken mortgage servicing down into three key sections.

First, let's talk about late payment fees. Is the amount consistent with the language in the note? Does the language differ between vendors? We see institutions using one LOS for mortgages and a different LOS for commercial loans, so make sure the amount you're disclosing and charging matches their note.

For loan late payment fees that are based on a percentage of a certain amount, verify whether the late payment fee is disclosed as a percentage of principal and interest, or principal and interest plus escrow. The Consumer Financial Protection Bureau (CFPB) found notes that indicated late fees would be collected in an amount of 4% of overdue principal and interest; however, when compared to the core system, it was calculating it on 4% of overdue principal, interest, taxes and insurance. A review of various loan documents as compared to core system parameters is worth the time.

Also note if a minimum or maximum late payment fee is disclosed on loan disclosures and promissory notes, and whether that amount matches the core system that actually generates the late payment fee. The CFPB found some institutions were disclosing a late fee of 5% of the portion of the installment of principal and interest that is overdue, but no more than $15. Yet the system was calculating a late fee in an amount greater than $15.

Timing of late charges can also be an Unfair or Deceptive Acts or Practices (UDAAP) issue. Does your loan documents state the late payment fee will be assessed on the 15th late date or after the 15th day, and does this language match the parameters? You must consider how your system calculates the day.

"On June 27, 2019, the Military Lending Act website enhanced security to their site. A user account is now required to access both the single record request and the multiple record requests."

Different loan documents may describe the late payment fee slightly differently. So if your core number is 15, understand how the core calculates 15 days, and compare the language on the agreement to what is in the core system to ensure late payment fees are assessed at the correct time.

Second, let's talk about PMI cancellation/ termination.

Institutions should be tracking dates and refunding any unearned premiums. You should take into consideration if you collected premiums at closing (for example, for an escrow cushion), as there will likely be unearned premiums. Don't rely on your mortgage insurance vendor to inform you if there is a refund due, as they may not be aware of any premiums collected at closing.

Additionally, the CFPB found institutions were being deceptive by misrepresenting the conditions for PMI removal. The Homeowners Protection Act (HOPA) requires servicers to cancel PMI if certain conditions are met. The consumer can request cancellation if the loan reached 80% of the loan-to-value based solely on actual payments, or the loan reached the date on which it was first scheduled to reach 80% based on the amortization schedule. The CFPB found borrowers who verbally requested cancellation were informed that they were declined because the loan had not reached 80% based on the amortization schedule, when in fact they had reached 80% based on actual payments. Although the borrowers did not satisfy other criteria necessary to trigger borrower cancellation rights under HOPA, such as certifying the property is unencumbered by subordinate liens or submitting the request in writing, the servicer did not provide these reasons for denying the request.

Third, let's talk about loss mitigation applications.

Regulation X requires servicers to exercise reasonable diligence in obtaining documents and information to complete a loss mitigation application. The CFPB found servicers were not meeting the reasonable diligence requirements.

Some servicers offered short-term payment forbearance programs during collection calls to delinquent borrowers who expressed interest in loss mitigation and submitted financial information that the servicer would consider in evaluating them for loss mitigation. The short-term payment forbearance programs deferred some or all of the past-due payments to the end of the loan, thereby extending the maturity. However, the servicer did not notify the borrowers that the short-term plan was based on an incomplete application evaluation. Near the end of the forbearance period, the servicer did not contact the borrower to inquire as to whether they wanted to complete the application and receive a full loss mitigation evaluation. The CFPB found this violated the requirement to exercise reasonable diligence in obtaining documents and information to complete the application.

8. Fair Lending

This remains a hot topic, and it's important to note that Fair Lending is not just about approving or denying the loan but also about how you treat the borrower throughout the entire process. Be sure that as part of your fair lending program you are assessing treatment during all phases of the loan, and you are providing training in all areas of the institution. Fair lending is not just a loan issue, it's a financial institutions issue.

Other things to note:

Ensure the assessment area makes sense and follows rules of the Community Reinvestment Act (CRA).

Pay attention to the area where you marketed and provided credit and where it could reasonably be expected for you to market and provide credit. It may not necessarily be the same area as your CRA assessment area; there may be expectations that this area is larger if your outreach area is larger than your CRA assessment area and if you receive applications from just outside the assessment.

And as for marketing, are you marketing in all areas that you service? Consider a redlining analysis. Examiners are asking for it.

9. Regulatory Guidance

Our last hot topic is regulatory guidance.

In September 2018, the agencies issued a statement clarifying the role of supervisory guidance. A law or regulation has the force and effect of law where supervisory guidance — which includes interagency statements, advisories, bulletins, policy statements, Q&As, and FAQs — does not have the force and effect of law. This means that supervisory guidance outlines the agencies' expectations or priorities and articulates their views regarding appropriate practices for a given subject area.

The agencies intend to limit the use of numerical thresholds or other bright lines in describing expectations in supervisory guidance. Also, per the Statement, examiners will not criticize an institution for a violation of supervisory guidance; rather, they may identify unsafe or unsound practices and provide guidance.

Note that while examiners can't cite you for failing to follow regulatory guidance, they can look for underlying and related regulations to cite. Regulatory guidance is there to protect the consumer and strengthen your CMS, so it benefits your financial institution to pay attention to regulatory guidance and implement it into your CMS.

Let's get started

Today's ever-changing regulatory environment can make it difficult for financial institutions to maintain an effective compliance management system.

Wipfli delivers a range of compliance solutions, including helping with compliance management systems, performing risk assessments, providing training and more. Click here to learn more about our regulatory compliance services, or continue reading on with these articles:

To err is human, to forgive is not standard practice for regulators

Why you should extend change management processes beyond regulation shifts

WIPFLI