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Vendor Management

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BNA INSIGHTS: Mortgage Industry Struggles to Avoid Vendor Management Land Mines

By Elizabeth McGinn and Moorari Shah

October 3, 2015, marked the official effective date of the long-anticipated, and widely dreaded, TILA-RESPA Integrated Disclosure (TRID) rule. Mortgage professionals have learned from a half-decade deluge of regulation that their TRID fate, along with almost every other aspect of the industry's ability to comply with the new regulatory regime, lies largely in the hands of third-party vendors.

Vendors ranging from independent mortgage brokers to disclosure preparation companies to settlement service providers span the entire origination process. In a rare acknowledgement of the problems associated with unreliable vendors, Consumer Financial Protection

Bureau (CFPB) Director Richard Cordray told an audience of mortgage bankers just two weeks into the TRID rule's existence:

> ''Some vendors performed poorly in getting their work done in a timely manner, and they unfairly put many of you on the spot with changes at the last minute or even past the due date. It may well be that all of the financial regulators, including the [CFPB], need to devote greater attention to the unsatisfactory performance of these vendors and how they are affecting the financial marketplace.''[1]

Cordray's remarks ultimately provide little comfort to mortgage lenders that must bear responsibility for vendors who fail to individually and collectively maneuver around TRID's many land mines. In that regard, the TRID rule is no different than any other industry-shifting paradigm advanced by the Bureau in its short but notable five-year reign.

Considerable investments to absorb and adjust to new laws and regulations have not altered the reality that coordinating the efforts of vendors will continue to determine whether the mortgage industry can ever conquer the heavy compliance burden it now faces. Along with vendor management concerns arising under the TRID rule, this article explores a number of mortgage industry challenges related to vendor management that have been the focus of intense CFPB enforcement efforts during the past year and are likely to continue into the foreseeable future.

Back to the Future

Throughout its existence, the CFPB's vendor management arsenal has had a familiar tendency, consisting mostly of (1) ominous guidance bulletins, (2) invective-laden enforcement actions, and (3) cryptic signals of future enforcement. In so doing, CFPB regulators have honed in on long-standing compliance pressure points involving third parties, including marketing services agreements (MSAs),[2] deceptive advertising of ancillary products,[3] and prohibited loan originator compensation.[4] In addition, a number of multi-party transactions, such as the delicate relationships among lenders, appraisal management companies (AMCs) and independent appraisers, figure to result in almost certain vendor management enforcement in the post-TRID era.

To be sure, other federal agencies such as the Federal Reserve Board (Fed)[5] and the Office of the Comptroller of the Currency (OCC)[6] have more modestly echoed the CFPB's warnings with respect to vendor relationships, and many in the mortgage industry have heeded the regulators' calls and wisely redoubled their efforts with respect to vendor management.

The efforts have resulted in, among other improvements, robust policies and procedures that cover vendor selection, contract negotiation and ongoing monitoring, as well as compliance training for everyone from the board of directors and senior management down to line-level employees. Nonetheless, whether because of the TRID rule or otherwise, many mortgage companies continue to grapple with fundamental changes to—and in some cases elimination of—age-old industry conventions.

Signaling the End of Marketing Service Agreements

With respect to MSAs, the CFPB has spent much of the past year targeting arrangements among lenders and third-party service providers integral to mortgage origination, such as real estate agents and title insurance companies.

More than a half-dozen public enforcement actions[7] announced in 2015 alone alleged egregious violations of the plain language of Real Estate Settlement Procedures Act (RESPA), which prohibits kickbacks or referral fees.[8] The latest CFPB broadside came in the form of a Compliance Bulletin issued October 8, 2015. The Bulletin outlined the Bureau's continuing reservations that MSAs could ever be crafted or monitored to avoid legal and regulatory risk. The announcement promptly led a major bank — the second in three months — to officially abandon MSAs for fear of being the next regulatory target.[9]

As a result, although still technically legal, stepping away from MSAs may be a sensible approach to mitigate regulatory risks in light of the CFPB's press release accompanying the issuance of the October 8 Bulletin. The press release noted the Bureau's enforcement actions against companies and individuals for RESPA violations had resulted in more than $75 million in penalties to date and that improper kickbacks and referral fees had been the basis of almost all of those actions. ''The CFPB intends to continue actively scrutinizing the use of such agreements and related arrangements in the course of its enforcement and supervision work,'' the

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

[2] *See* Consumer Financial Protection Bureau. CFPB Compliance Bulletin 2015-05, RESPA Compliance and Marketing Services Agreements (Oct. 8, 2015).

[3] *See* In the Matter of Paymap Inc., Consent Order File No. 2015-CFPB-0017 (July 28, 2015), http://files.consumerfinance.gov/f/201507_cfpb_consent-order_paymap.pdf; *See also* In the Matter of LoanCare, LLC, Consent Order File No. 2015-CFPB-0018 (July 28, 2015), http://files.consumerfinance.gov/f/201507_cfpb_consent-order_loan-care.pdf.

[4] Consumer Fin. Prot. Bureau, *Supervisory Highlights: Summer 2015 at* 11 (June 23, 2015), http://files.consumerfinance.gov/f/201506_cfpb_supervisory-highlights.pdf.

[5] Fed. Reserve Bd., Divs. of Banking Supervision & Regulation & of Consumer & Cmty. Affairs, FRB Letter No. SR 13-19 (Attachment), *Guidance on Managing Outsourcing Risk* (Dec. 5, 2012), *available at* http://www.federalreserve.gov/bankinforeg/srletters/sr1319a1.pdf.

[6] Office of the Comptroller of the Currency, OCC Bull. No. 2013-29, *Third-Party Relationships: Risk Management Guidance* (Oct. 30, 2013), *available at* http://occ.treas.gov/news-issuances/bulletins/2013/bulletin-2013-29.html.

[7] *See, e.g., In the Matter of PHH Corporation, et al.*, File No. 2014-CFPB-0002 at p. 18 (stating that payments for services are only ''bona fide'' under RESPA . . . if they ''are solely for services actually performed (i.e., not for referrals). . . .''

[8] *See* 12 U.S.C. 2607(a).

[9] ''CFPB, Regulatory Concerns Drive Bank of America Out of MSAs,'' *HousingWire*, October 14, 2015.

press release said.[10] Based on this thinly veiled ''guidance,'' it would appear that any legal support for MSAs is, at least in the eyes of the CFPB, a dead letter.[11]

Targeting Mortgage Add-On Products

On the topic of ancillary products, the CFPB took simultaneous action against two service providers—a mortgage loan servicer and its payment processor—leading to a total of $33.4 million in remediation and penalties. The conduct purportedly at issue was deceptive marketing of an ''equity accelerator'' product that the payment processor had partnered with the loan servicer to sell, promising customers that loans could be paid off sooner than the original maturity date with ''over $33,000 in interest savings.''[12]

Although the Bureau has previously taken aim at deceptive mortgage advertising as it relates to mortgage origination (often in the context of allegations of implied government affiliation[13]), this latest action against the mortgage loan servicer and its payment processor in connection with the ''equity accelerator'' product, was more akin to enforcement actions frequently seen with credit card companies,[14] auto finance companies[15] and, more recently, mobile telephone providers.[16]

In particular, similar to the posture taken by the Bureau with credit card and auto add-on products, the CFPB took aim at the supposed exaggeration of claims in the marketing materials, finding that ''only a tiny fraction of consumers who enrolled in the Equity Accelerator Program achieved interest savings of over $33,000 from participating.'' Moreover, at a macro level, the enforcement action related to an ancillary product that has been in the marketplace for years. The action also reiterated the CFPB's expectations regarding joint financial institution and vendor accountability related to compliance with federal consumer financial laws prohibiting unfair, deceptive or abusive acts or practices in violation of 12 U.S.C. 5536(a)(1)(B).

Market Misalignment with Loan Originator Compensation Rule

In June 2015, the CFPB announced an action against Guarantee Mortgage Corporation (GMC) for failure to abide by the Loan Originator Compensation Rule (the LO Rule), which is applicable to employee loan originators as well as third-party originators such as correspondent lenders.[17] In particular, the Bureau took exception with GMC's payments to branch managers based, in part, on the interest rates of the loans they closed.

Since 2011, the CFPB has enforced 12 C.F.R. § 1026.36(d), which prohibits loan originator compensation based ''directly or indirectly on a term of the transaction.'' As stated in the CFPB's *Summer 2015 Supervisory Highlights*, ''The [LO Rule] . . . protects consumers from being steered into costlier loans by prohibiting loan originators from receiving compensation based on the interest rates of the loans they close.''[18]

In reality, however, it is not just interest rates that are subject to loan originator compensation restrictions; any additional compensation to loan originators tied to common residential loan features (such as pre-payment penalties or adjustable rate provisions) are ''terms of the transaction,'' for which loan originators cannot be compensated. The traps for the unwary also arise in the context of securitizations that seek to pool certain types of loans and pay investors accordingly for the risk-reward propositions inherent in different loan products, such as interest-only and negative amortization loans.

As such, for lenders that have every incentive to reward loan originators that generate more profitable loans, the result of the LO Rule may appear counterintuitive. The resulting market misalignment ensnared GMC, which ultimately cost the company $228,000 in civil penalties and caused it to go out of business.[19] In a nutshell, while the mortgage industry adjusts to the TRID rule, the Bureau has hinted that the LO Rule is just as likely an area of enforcement activity in the coming months.

Appraiser Independence Requirements Hinder Vendor Management

Appraisals represent another area of considerable concern for lenders attempting to manage a dizzying array of vendors, each with its own unique challenges. On the surface, managing appraisers seems relatively straight-forward, since all appraisers are generally required to be licensed in the states in which they perform real property appraisals.[20]

However, confirming licenses alone will not satisfy a mortgage lender's obligations to vet and continuously monitor its appraisers. Rather, regulators and investors

[10] ''CFPB Provides Guidance About Marketing Services Agreements,'' CFPB Press Release (October 8, 2015), available at http://www.consumerfinance.gov/newsroom/cfpb-provides-guidance-about-marketing-services-agreements.

[11] *See also* Consumer Fin. Prot. Bureau, *Supervisory Highlights: Fall 2015 at* 42 (Nov. 3, 2015), http://files.consumerfinance.gov/f/201510_cfpb_supervisory-highlights.pdf.

[12] *See supra* In the Matter of Paymap Inc., Consent Order File No. 2015-CFPB-0017 at 6.

[13] *See, e.g.*, In the Matter of Flagship Financial Group, LLC, Consent Order File No. 2015-CFPB-0006 (February 12, 2015).

[14] *See, e.g.*,In the Matter of Citibank, N.A.,; Department Stores National Bank; and Citicorp Credit Services, Inc. (USA), Consent Order File No. 2015-CFPB-0015 (alleging misrepresentation or omission of costs, terms, benefits or material limitations of a number of credit-card add-on products).

[15] *See, e.g.*, In the Matter of U.S. Bank National Association, Cincinnati, Ohio, Consent Order File No. 2013-CFPB-0003 (June 27, 2013) and In the Matter of Dealer Financial Services LLC Consent Order File No. 2013-CFPB-0004 (June 27, 2013) (alleging failure to provide disclosures and misrepresentations of costs and fees for vehicle service contracts and GAP insurance products).

[16] *See e.g., Consumer Financial Protection Bureau v. Sprint Corporation*, Civil Action No. 14-cv-09931, Stipulated Final Judgment and Order (S.D.N.Y. 2015) (alleging illegal charges (i.e., ''cramming'') made to customers by third parties).

[17] In the Matter of Guarantee Mortgage Corporation, Consent Order File No. 2015-CFPB-0011 (June 5, 2015).

[18] *See, supra,* Consumer Fin. Prot. Bureau, *Supervisory Highlights: Summer 2015 at* 22 (June 23, 2015), http://files.consumerfinance.gov/f/201506_cfpb_supervisory-highlights.pdf.

[19] *Id.*

[20] *See* 12 U.S.C. § 3342 (applicable to regulated banking institutions and describing criteria for transactions requiring services of state-certified appraisers).

expect considerably more, including strict adherence to appraiser-specific statutory and regulatory requirements, not to mention compliance management systems (CMS) that track each appraiser's compliance with applicable federal consumer financial laws.[21]

Moreover, an added wrinkle with appraisers arises due to appraiser independence requirements which are codified in the Truth in Lending Act (15 U.S.C. § 1639e) and Regulation Z (12 C.F.R. § 1026.42). Such requirements increase the risk of regulatory violations for lenders and AMCs that have grown accustomed to tried-and-true results-oriented vendor oversight methods, because the typical system of rewards and penalties designed to incent vendors to produce desired outcomes is essentially banned under current law.

Specifically, the role of the appraiser is to provide an independent and impartial analysis of real property. This analysis is a critical component of the mortgage transaction and, over the past five years, new laws, rules, and regulations have been implemented in an effort to protect the independence of the appraiser. To that end, the CFPB Mortgage Origination Examination Procedures emphasize, in particular, two aspects of vendor management that CFPB examiners will be especially mindful of during the course of examinations: (1) whether the practices of the mortgage lender or its employees undermine appraisal independence, and (2) whether the entity maintains adequate oversight of the appraisers it uses (including termination where necessary) and safeguards against appraisal fraud.[22]

Competing Multiparty Interests under Regulation Z Create Potential for Inconsistent Results

Major investors such as Fannie Mae and Freddie Mac have also sought to reinforce the independence requirements with their own rules requiring segregation of duties among those lender employees that select and retain appraisers and AMCs and those lender employees that play any role in the sales and mortgage production process.[23]

Such a divide-and-conquer approach, however, would generally be considered the antithesis of a sound vendor management policy pursuant to which an organization has multiple contacts with the same vendor and shares management responsibilities and insights regarding the vendor throughout the organization.

Suffice it to say then that attempting to synthesize appraiser independence rules alongside third-party risk management principles enunciated by regulators in recent years has proven perplexing to a number of mortgage lenders. Furthermore, the tenuous three-party relationship between lenders, AMCs and individual appraisers all seeking to comply with applicable statutes and regulatory guidance has become considerably more complicated and led to counterproductive processes.

For example, consider the following 2015 state enforcement matter related to appraiser compensation. The Louisiana Real Estate Appraisers Board (LREAB) took action against an AMC, resulting in $5,000 in administrative costs and a strict requirement to adhere to a prescribed schedule of appraiser fees.[24] LREAB had alleged that the AMC had not used established fees set by an objective third party or use the factors set forth in Louisiana law in determining fees paid to appraisers; such conduct would also be a violation of the ''customary and reasonable compensation'' rules that protect appraisers under Regulation Z.[25]

However, Regulation Z also requires AMCs and lenders to fulfill ''valuation management functions,'' including ''reviewing or verifying the work of a person that prepares valuations'' and ''withholding compensation due to breach of contract or substandard performance of services.''[26] With competing interests of vendor management, appraiser independence, and fair compensation built right into the same regulation, it's not hard to imagine the opportunities for frequent disagreement amongst lenders, AMCs and appraisers, all potentially having a colorable argument that they are simply trying to follow applicable laws and regulations.

Conclusion

On the surface, CFPB Director Cordray's mention of vendor shortcomings in connection with the roll-out of the TRID rule appeared to be a startling admission during an annual gathering of mortgage bankers. However, nothing about Cordray's comments should be taken to signal a reprieve from the CFPB's and other regulators' expectations related to managing vendor risks. In fact, the Bureau's actions throughout the past year suggest quite the opposite, as the depth and breadth of enforcement actions related to inadequate vendor oversight are likely to deepen and broaden for the foreseeable future.

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[21] *See, e.g.*, CFPB Mortgage Origination Examination Procedures at 43 (September 2015); *see also* Fannie Mae Lender Letter LL-2015-02 (February 4, 2015), https://www.fanniemae.com/content/announcement/ll1502.pdf

[22] CFPB Mortgage Origination Examination Procedures at 42 (September 2015).

[23] ''Appraiser Independence Requirements,'' Fannie Mae, p.2 (October 15, 2010).

[24] Stipulations and Order, dated as of May 28, 2014, between Coester Appraisal Management Group and Louisiana Real Estate Appraisers Board, available at http://orep.org/wp-content/uploads/2015/06/Coester-Stipulation-Order.pdf.

[25] *See* 26 C.F.R. § 1026.42(f).

[26] *See* 26 C.F.R. § § 1026.42(b)(4)(ii), (c)(3)(v).