An Overview: Implications of Increased Regulatory Oversight on Business Process Outsourcing (BPO) in the Mortgage Origination and Servicing Industry
Many reasons have been advanced for the cause of the financial crash, including financial services deregulation, lax oversight, loose lending policies, and dubious practices in the financial securities ratings agencies. The result has been, among other things, the current challenges facing the mortgage origination and servicing industries. The housing crash and subsequent recession put a government spotlight on the need to re-regulate the mortgage-lending industry in the United States. What has emerged is a federal government energized to regulate every aspect of the industry. Congress' solution has been to rewrite and add on to statutes and agency regulations, adding multiple new routines and levels of responsibility in an effort to ensure consumer protection.

The financial services industry has never been required to treat consumer protection like other industries. Most rules were made to protect investors and institutions while keeping the overall financial system operating and cash flowing through the economy. With the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), consumer protection has become central to the government's efforts to regulate both the industry. This overt attention and paramount orientation to protecting consumers (at any cost...and the cost is expected to be enormous) will have significant implications for banking and nonbanking institutions.

The new super regulator created as a result of Dodd-Frank is already busy creating new rules to ensure consumer protection and will require supervised banking and nonbanking institutions intent on increasing their market share of the U.S. home loan market to master the art and science of risk management and regulatory compliance. In truth, lenders must learn to deal with an increasingly complex regulatory environment if they hope even to retain the level of business they enjoyed pre-crash.

While lenders are risk averse by nature, they have never encountered this level of regulatory oversight. Issues surrounding this regulator's creation of the Qualified Resident Mortgage (QRM), the Single Point of Contact (SPOC) rule for mortgage services and Loan Officer Compensation, among other examples, have sent the industry into retreat as firms struggle through a deep cycle of process re-engineering. Meanwhile, mortgage banking executives find themselves in the unenviable position of having to maintain their business/market share while effectively re-thinking every aspect of their businesses.

These issues are not just internal, but also external, as lenders are responsible for the actions of every third-party provider they utilize as part of their Business Process Outsourcing (BPO) initiatives. Because mortgages are a complicated financial instrument, this extends to IT providers, Appraisal Management Companies (AMCs), Title Underwriters and all other forms of BPO.

In this, the first of three (3) papers on the implications of increased regulatory pressures on mortgage origination and servicing, we provide an overview of the new landscape with specific attention to some of the key differences, and challenges that await mortgage bankers, as the regulations continue to unfold.

The New Horizon: Scrutinizing Third-Party Providers

The Bureau of Consumer Financial Protection ("CFPB" or "Bureau") is a cornerstone of the recently passed Dodd-Frank Wall Street Reform and Consumer Protection Act. The Bureau's purpose is to "make markets for consumer financial products and services work for Americans — whether they are applying for a mortgage, choosing among credit cards, or using any number of other consumer financial products."  

Most media attention has focused on the well-publicized matter of the constitutionality of the statutory shield that envelopes the regulator from congressional oversight (for now), it is the steady stream of seemingly activist regulations coming out of the Bureau that has mortgage bankers worried.

Although it is a new agency, CFPB’s focus on consumer protection creates for banking institutions a new and challenging regulatory infrastructure based not upon the safety and soundness of the institution, the traditional standard within the five member FFIEC, but on consumer protection. Here is why it is such a shift.

The five member agencies of the Federal Financial Institutions Examination Council (FFIEC), most of which were created by Congress following passage of the Depression-era Glass-Staegall Act, are charged jointly and separately with oversight of banking institutions. In this role, the agencies conduct audits, issue guidance, investigate wrongdoing, and work with the federal justice system to rid the industry of bad actors. The idea of "safety and soundness," as in assuring the safety and soundness of the banking institution, became and remains the standard for the agencies upon which to enact regulations. It wasn't until the last decade of the last century that the Agencies began to concern themselves with the activities of third-party suppliers to these regulated institutions.

Y2K changed that.

By the late 1990's, many critical banking functions previously carried out by tellers, accountants, clerks, and bankers evolved into automated routines made possible by the introduction and rapid growth of computerization. As the New Millennium approached, concerns about the effects of the new century on computer operations, what was popularly referred to as Y2K, loomed large.

Leading up to the final year-end of the century vast amounts of human and financial resources poured into the effort to avoid what many conjectured to be financial Armageddon. While the Y2K crisis did little actual harm to the financial system, the experience taught overseers a valuable lesson. In their zeal to protect the safety and soundness of the banking institutions per se little emphasis was placed on the safety and soundness, and potential for strategic, operational, reputational, reporting, and compliance risks, posed by third party providers of products and services that banks increasingly contracted.

During the past decade, FFIEC member agencies issued at least 5 separate bulletins aimed at providing guidance on managing risks in third-party relationships.

FDIC FIL-44-2008: Guidance for Managing Third-Party Risk

This bulletin describes potential risk arising from third-party relationships and outlines risk management principles that may be tailored to suit complexity and risk potential of a financial institution’s significant third-party relationships.


The FDIC has prepared (this) guidance to address the risks inherent in outsourcing relationships between U.S. financial institutions and foreign-based third-party service providers. The guidance provides steps that institutions should take to successfully manage such risks.


The purpose of the attached guidance is to assist financial institutions in identifying those risks posed by the use of weblinks on their websites and to suggest a variety of risk management techniques institutions should consider using to mitigate these risks. This guidance applies to institutions that develop and maintain their own websites, as well as institutions that use third-party service providers for this function.

OCC 2002-16: Bank Use of Foreign-Based Third-Party Service Providers | May 15, 2002

This bulletin provides guidance to national banks on managing the risks that may arise from their outsourcing relationships with foreign-based third-party service providers. It also addresses the need for a national bank to establish relationships with foreign-based third-party service providers in a way that does not diminish the ability of the OCC to access, in a timely manner, data or information needed to effectively supervise the bank’s operations.

OCC 2001-47: Third-Party Relationships

This bulletin provides guidance to national banks on managing the risks that may arise from their business relationships with third parties.


The FDIC, together with the other federal regulators of banks, thrifts and credit unions, issued the attached joint guidance on managing the risk exposure an institution faces when it uses outside firms for technology.
The new emphasis on consumer protection will amount to a Y2K-like rush by leaders of CFPB-supervised institutions to review virtually every aspect of their mortgage operations to find and fill compliance gaps, both real and perceived; all within the rubric of a fluid rule-making environment.

The Consumer Protection Infusion: CFPB Bulletin 2012-03

In an April 13, 2012 bulletin (CFPB Bulletin 2012-03), the Consumer Financial Protection Bureau announced new expectations regarding working relationships that supervised banks and nonbanks engage in with third party providers of services. These expectations, broadly defined and in most cases narrowly explained (if at all), are intended to assure the agency that banks and nonbanks relationships with service providers are conducted in compliance with applicable federal consumer financial laws. As a recent paper by K&L Gates points out, application of its terms only to “federal consumer financial laws” results in an expansive list of applicable statutes (subject to certain limitations), including the following:

- Consumer Leasing Act
- Electronic Fund Transfer Act
- Equal Credit Opportunity Act
- Fair Credit Reporting Act
- Fair Debt Collection Practices Act,
- Federal Deposit Insurance Act
  (subsections (b) through (f) of section 43
- Gramm-Leach-Bliley Act (sections 502 through 509)
- Home Mortgage Disclosure Act
- Real Estate Settlement Procedures Act
- S.A.F.E. Mortgage Licensing Act
- Truth in Lending Act
- Truth in Savings Act
- Omnibus Appropriations Act, 2009
  (section 626)
- Interstate Land Sales Full Disclosure Act

It is not yet clear how the Agency will manage these expectations, but some are already suggesting—and with good reason—that mortgage lenders and servicers that fall under CFPB supervision should begin considering all third-party providers of services as extensions of their own businesses and should plan to be held accountable for everything that impacts consumers whether it occurs within their own walls or not.

Definitions: Supervised Banks and Nonbanks, and Supervised Service Providers

According to CFPB Bulletin 2012-03, supervised banks and nonbanks refers to entities supervised by the CFPB, specifically, large insured depository institutions, large insured credit unions, affiliates of these organizations, and certain non-depository consumer financial services companies. It is unclear as yet whether smaller institutions unaffiliated with any of these so-called supervised banks and nonbanks will fall under the Bureau’s oversight. But for now it seems they’ll be exempted... but still bound by applicable FFIEC regulatory requirements.

Significant in the Bulletin is the regulatory arm extended around BPO providers, third-party service organizations contracted by supervised institutions to conduct certain functions that the banks would otherwise have to manage in-house. CFPB refers to these third-parties as supervised service providers; service providers to supervised banks and nonbanks, and service providers to a substantial number of small insured depository institutions or small insured credit unions.

The term Service provider, the Bureau points out, is generally defined in section 1002(26) of the Dodd-Frank Act as “any person that provides a material service to a covered person in connection with the offering or provision by such covered person of a consumer financial product or service.”

A service provider, according to the Bulletin, may or may not be affiliated with the person to which it provides services.

FFIEC Regulations Stacked with CFPB Consumer Protections

Perhaps as a means to portray the new regulatory regime as nothing more than clarification of existing regulation—thus avoiding the Administrative Procedure Act—the Bureau affirms the value that the use of third party service providers bring to the mortgage banking sector; as mentioned, FFIEC made the same case in numerous bulletins.

Essentially, the Bureau expects supervised banks and nonbanks to have effective processes in place for managing the risks of service provider relationships. The CFPB thus cautions supervised institutions that to "limit the potential for statutory, or regulatory violations and related consumer harm, supervised banks and nonbanks should take steps to ensure that their business arrangements with service providers do not present unwarranted risks to consumers."

These steps, according to the agency, should include, but are not limited to:

- Conducting thorough due diligence to verify that the service provider understands and is capable of complying with Federal consumer financial law;
- Requesting and reviewing the service provider’s policies, procedures, internal controls, and training materials to ensure that the service provider conducts appropriate training and oversight of employees or agents that have consumer contact or compliance responsibilities;
- Including in the contract with the service provider clear expectations about compliance, including appropriate and enforceable consequences for violating any compliance-related responsibilities, including engaging in unfair, deceptive, or abusive acts or practices;

4. CFPB notes in Bulletin 2012-3 that “Federal consumer financial law is defined in section 1002(14) of the Dodd-Frank Act (12 U.S.C § 5481(14)).”
Establishing internal controls and on-going monitoring to determine whether the service provider is complying with Federal consumer financial law; and

Taking prompt action to address fully any problems identified through the monitoring process, including terminating the relationship where appropriate.

New Opportunities and Challenges for BPO Clients and Vendors

Most industry participants realize that these new rules change every business process that is currently outsourced by a supervised institution. No one outside of government is suggesting that supervised banks and mortgage servicing operations currently have the staff to get this work done. And, in fact, not even the government is suggesting that the industry can do this on its own, as evidenced by the consent orders issued on April 13, 2011, by the Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) against 12 mortgage servicers requiring them to retain independent consultants to conduct a multi-faceted independent review of foreclosure activities in 2009 and 2010.

In effect, the consent order required the industry’s largest servicers to hire third-parties to analyze and then re-engineer their third party relationships. This, we expect, will become the template for the way the government requires industry participants to analyze and remediate problem relationships in the future.

J. P. Morgan Chase provides a recent example from the marketplace. The institution recently placed its primary property preservation and rehabilitation vendor on hold for 90 days, a moratorium mandated by the bank’s need to work through audits required by the consent order. Every work order the bank had out relating to vacant or REO properties was placed on hold while the firm determined whether an audit was required under the consent order, exactly what audit was required and then have the audit carried out. Upon completion, the audit were passed to third parties, which then built out plans to address the audits, implemented those plans and then tested and controlled those plans. In the process, the institution spent millions of dollars auditing and then refining a service that is a pure cost center to the mortgage loan servicer.

And this type of compliance scenario is not limited to the serving sector. It has started in earnest in default, foreclosure and REO processes, but is expected to expand to all other functions within the next six to 12 months. Choosing the wrong partner to work through these issues will put more than a few companies out of business permanently.

Fortunately, BPO is a mature offering, especially in the U.S. financial services business. These third parties are available and up to this task. Still, only those providing the latest generation of BPO will be in a position to help mortgage participants succeed in this environment.

As illustrated below, the BPO business has already advanced through a number of generational maturations. From the first generation Pioneers of the late 1990s, when work was lifted out of the enterprise and shifted to onshore outsourcers, the approach to BPO has grown over the years. Second generation, in the early 2000s, saw the work lifted and shifted to low-cost offshore outsourcers, taking advantage of savings through labor arbitrage. By the mid 2000s, the business had shifted again, this time into its third generation where “middle offices” offered up full-time employees who worked on the clients own technology platforms to complete the work.

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**Evolution of the BPO Market Accenture Differentiation**

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<td>FS Industry, F&amp;A and HR</td>
<td>More back office and industry processes</td>
<td>Moving into the “middle office”</td>
<td>All “offices” with more industry focus</td>
<td>Offerings with standard platforms &amp; process</td>
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<td>Deals</td>
<td>Pioneering mega deals with lift &amp; shift focus</td>
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<td>Platforms</td>
<td>Intend to use client platforms for 1:many</td>
<td>Client’s own platforms</td>
<td>Mostly client’s own platforms</td>
<td>Providers adding analytics tools</td>
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<td>Client Objectives</td>
<td>Cost savings, transfer people and technology to providers</td>
<td>Cost savings and global capability</td>
<td>Cost savings, global capability and “noiseless” delivery</td>
<td>Cost, global, “noiseless”, industry depth, analytical insight and innovation</td>
<td>Cost, global, “noiseless”, industry insight, innovation and flexibility</td>
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Today, the market's leaders are in the fourth generation of BPO, where every outsourcer is considered simply another “office” of the primary enterprise. Analytical tools and global capabilities allow outsourcers to focus on business outcomes, giving back to the enterprise cost savings, industry depth, analytical insight and innovation.

These regulatory requirements call for an additional layer to the BPO offerings we've seen in the past, a compliance layer that provides the protection the mortgage enterprise needs without requiring the institution to staff up in order to send work outside. Many specialized third-party suppliers will not be in a position to offer this, which provides an opportunity for those that can.

It is also highly likely that the market will experience more consolidation or alliance building among BPO providers. We've already witnessed this in the default servicing area, where specialty servicers and niche consultancies sprang up after the turn of the century, only to suffer from attrition or fall prey to acquirers or consolidation as the wave of defaults and foreclosures crested and passed. We expect to see another such wave, but this time those firms that cannot provide the compliance layer required will leave the business or bundle their offering with other firms that can provide it.

As these opportunities present themselves and the BPO niche consolidates services, it may provide economies of scale that can provide better pricing for larger buyers. Those lenders not in a position to leverage this scale will find that their third party relationships are not only more expensive to manage but also have higher risk and a potentially larger downside as those BPO providers that can offer the required compliance support find themselves in a position to charge more.

In the papers that follow, we'll talk more about the specific consequences we see this new regulatory burden having on the mortgage banking operation and share some strategies for dealing with the increased workload in a compliant manner, for both the enterprise as a whole and for the institution's IT department.