Compliance Insights

Your monthly compliance news roundup

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Consumer Compliance Implications of LIBOR Replacement

Much has been written about the issue of LIBOR replacement and the potential risks that could arise absent prudent planning by impacted stakeholders. Although the financial impact has been widely discussed, consumer-compliance concerns appear to have garnered little attention. That is not to say there is an absence of risk. LIBOR, or the London Interbank Offer Rate, is one of two interest rate benchmarks commonly used for repricing adjustable rate mortgage (ARM) loans, with the other being the Constant Maturity Treasury (CMT) rate. LIBOR is also commonly used for repricing adjustable rate home equity lines of credit (HELOCs). If LIBOR is discontinued, a significant percentage of ARM loans and HELOCs will have to be modified to establish a replacement index, and that could lead to a host of other concerns.

For those less familiar with the topic, LIBOR's expected termination sometime after 2021, if not sooner, was caused by its association with numerous scandals and questions about its sustainability. The potential for this occurrence, known for some time, has facilitated a robust level of transition planning. The primary architect of the LIBOR transition for U.S. financial institutions is a working group known as the Alternate Reference Rate Committee (ARRC), made up of private-market participants convened in 2014 by the Federal Reserve Board and the New York Fed to help ensure a successful transition from LIBOR. The ARRC resolved the most prominent issue, the selection of a recommended replacement index, as far back as 2017, when it selected the Secured Overnight Financing Rate (SOFR) as the best option.

From a consumer compliance perspective, the primary concern regarding LIBOR replacement impacts both the origination and servicing of new and existing ARM loans, as well as adjustable rate HELOCs. Since LIBOR will likely be replaced by the SOFR in the United States, the most significant concern relates to the contract language that governs this

replacement. In March 2018, the ARRC issued its *Second Report*, which, among other things, addressed the LIBOR transition risk in mortgage and other consumer products. The report noted that most ARM contracts have clear language allowing the noteholder to choose a new index if the existing index is no longer available. While this is helpful, the ARCC report noted that most contracts were silent regarding other aspects of index replacement. Of primary concern is whether the noteholder is authorized to adjust the interest rate margin to account for differences in index rates between LIBOR and SOFR.

Although mortgage servicing presents the most obvious challenge with respect to LIBOR replacement, additional considerations exist with respect to mortgage origination. Noting the ambiguity in existing mortgage contracts regarding index replacement, in November 2019, the ARRC issued guidance on how such language could be adjusted on new loan originations, so-called fallback language that will ensure more expeditious resolution if and when LIBOR is replaced. Institutions should consider whether to adopt such language in new loan originations that are tied to LIBOR.

Financial institutions that originate or service ARM loans or adjustable rate HELOCs should consider acting now if they have not yet done so. A first step in the process would be to identify the extent to which the institution services loans, whether ARMs or HELOCs, that are tied to the LIBOR index. A next step might involve reviewing the contract language for each type of variable rate mortgage to determine whether and how it addresses index replacement. These two steps should provide a preliminary indication of the level of effort which may be needed. Personnel responsible for maintenance of loan servicing systems should also be informed and inquiries should be made of third-party servicers as to their preparedness for facilitating such changes. Institutions should also be attentive to future regulatory guidance addressing the issue of LIBOR replacement in the context of consumer protection.

Fed Vice Chair Quarles' Calls for Banking Supervision Reforms

On January 17, Randal Quarles, the Federal Reserve Board's vice chair for supervision, shared his thoughts on the process of bank supervision in remarks made to the American Bar Association's Banking Law Committee. Quarles addressed the need for more transparency and clarity in the bank supervisory process, focusing specifically on three areas: large bank supervision, general transparency improvements and overall supervisory improvements.

Large Bank Supervision

With respect to large bank supervision, Quarles focused on transparency in the composition of the Federal Reserve's supervisory portfolios and in the stress test component of the Comprehensive Capital Analysis and Review (CCAR) requirements. Regarding the supervisory portfolios, he addressed the Large Institution Supervision Coordinating Committee (LISCC), a Federal Reserve System-wide committee that oversees the supervision of the largest, most systemically important financial institutions in the United States.

Quarles, who said there is no clear and transparent standard for identifying LISCC firms, proposes that such a standard be developed. Aligning the LISCC portfolio with the definition of Category I firms under the Federal Reserve's recent tailoring rules would be an appropriate change, he added. Also, Quarles suggested publishing the internal procedural materials the Fed uses to supervise LISCC firms as another method of improving transparency.

Regarding stress tests under CCAR, Quarles said he is looking for ways to make them more transparent without reducing their effectiveness and making them "game-able." He proposed three ideas for meeting this objective, including providing more transparency on the models and scenarios used, giving banks more time to review their stress test results before requiring a final capital plan, and reducing the volatility of stress test requirements from year to year.

General Transparency Improvements

In addition to addressing transparency concerns related to large bank supervision, Quarles proposed three actions that would improve transparency for all supervised institutions. First is creating a word-searchable database on the Federal Reserve's website containing historical regulatory interpretations issued by the board and its staff for all significant rules. While certain interpretations and guidance documents are available on the Federal Reserve's website, the resources are not comprehensive or user friendly, he added.

Second, he suggests that transparency would be approved by the Federal Reserve putting significant supervisory guidance out for public comment. Lastly, Quarles indicated he supports submitting significant supervisory guidance to Congress for purposes of the Congressional Review Act. Such a move, he adds, would enhance the Federal Reserve's accountability and help build support for supervisory guidance.

Overall Supervisory Process Improvements

Quarles voiced support for the following ideas that he said would improve the supervisory process:

- Increasing the ability of supervised firms to share confidential supervisory information with employees, affiliates, service providers and other government agencies to promote compliance and facilitate the response to enforcement actions
- Having the board adopt a rule on how the Federal Reserve uses guidance in the supervisory process and, in doing so, affirm that guidance is not binding and noncompliance with guidance may not form the basis for an enforcement action
- Restoring the category of "supervisory observation" for less significant safety and soundness issues, a category that was removed by the Federal Reserve in 2013
- Limiting future matters requiring attention (MRAs) to violations of law, regulation, or material safety and soundness issues
- Making the Federal Reserve's practice of having independent review of important supervisory communications and guidance documents a more routine process.

While the timeline for implementing the bank supervision reform has not been confirmed, Quarles indicated that it is a top priority for 2020. Financial institutions will want to continue to monitor as progress on the reforms unfold.

Governors Propose Expansion of State Consumer Financial Protection Oversight

As indicated in last month's edition of ***Compliance Insights***, state law oversight of consumer compliance requirements increased in 2019, a trend we expected will continue throughout 2020. Indeed, just a month into the new year, two states moved to expand the reach of their financial institution regulatory bodies.

In a proposed 2020–2021 budget addressed to members of the Senate and the Assembly of the California Legislature, Governor Gavin Newsom introduced a measure that would afford state officials power to expand the Department of Business Oversight (DBO) to "protect consumers and foster the responsible development of new financial products." To that end,

Newsom's proposal would rebrand the DBO as the Department of Financial Protection and Innovation (DFPI), provide for $10.2 million for a financial protection fund and create 44 new positions within DFPI to enhance consumer protection. The agency's oversight would expand from regulation of certain financial services and overseeing state-licensed financial institutions to authority over unlicensed financial services providers not currently subject to regulatory oversight, such as debt collectors, credit reporting agencies, and financial technology (fintech) companies, among others.

With increased state authority, the agency could offer consumer protection against unfair, deceptive or abusive activities – practices normally overseen by the Consumer Financial Protection Bureau (CFPB) – or examine industries that are underregulated. California consumers may also benefit from educational services the DFPI would provide for individuals of various ages, as well as immigrants and members of the military, in hopes to stave off abusive practices.

Similarly, Governor Andrew Cuomo of New York, in his 2020 State of the State agenda, proposed increasing state oversight of unfair, deceptive or abusive activities in connection with financial products and services. Cuomo took it a step further by proposing state legislation that aligns more fully with federal law and allows state authorities greater ability to bring enforcement actions against violators. This could mean consumer products or services enforced by the CFPB would also be enforced by state authorities. Cuomo stated he would like to enhance the Department of Financial Services (DFS) authority to collect damages, effect restitution and increase monitory penalties under the Financial Services Law from $5,000 per violation to $5,000 per violation or double damages/monetary gain. The DFS would also regulate debt collectors.

While state and local oversight of financial services or practices is nothing new, as seen in a variety of states that have cease-and-desist orders or enforcement actions against financial institutions, proposals to create state-based extensions of the CFPB are relatively new. With de facto federal deregulation still on the minds of many, it is likely more states will take similar steps to enforce CFPB-like regulations to protect consumers from financial harm. Financial institutions should keep abreast of these state regulations and laws, as well as significant changes to the purview of state financial institution regulations.

CFPB Clarifies 'Abusive' Standard

The Dodd-Frank Act (DFA), enacted in 2010, was the first federal law to prohibit abusive acts or practices in the provision of consumer products or services. This standard applies to any transaction with a consumer for a consumer financial product or service, or the offering

of a consumer financial product or service and affects all covered persons (i.e., persons that provide consumer financial products and services), service providers and persons that provide substantial support to abusive conduct.

The DFA prescribed that the Consumer Financial Protection Bureau (CFPB) could deem an act to be abusive only if it:

- Materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service
- Takes unreasonable advantage of a consumer's lack of understanding, a consumer's inability to protect him/herself, or a consumer's reliance on a covered person or service provider.

Now, nearly a decade later, the CFBP has acknowledged the continuing uncertainty in the scope and meaning of *abusive* by issuing a policy statement to provide more clarity on how it intends to apply this standard. Specifically, the bureau's policy states that it intends to apply the following principles during supervision and enforcement work:

- Focus on citing or challenging conduct as abusive in supervision and enforcement matters only when the harm to consumers outweighs the benefit.
- Generally, avoid dual pleading of abusiveness and unfairness or deception violations arising from all or nearly all the same facts, and alleging stand-alone abusiveness violations that demonstrate clearly the nexus between cited facts and the bureau's legal analysis.
- Seek monetary relief for abusiveness only when there has been a lack of a good-faith effort to comply with the law, except that the bureau will continue to seek restitution for injured consumers regardless of whether a company acted in good faith or bad faith.

While the CFPB hopes that the policy statement will bring much-needed clarity, in the press release announcing the policy statement, it raised the possibility of a future rulemaking to define the abusive standard further.

Financial institutions can review the CFPB's *Supervisory Highlights* for examples of certain fact patterns in enforcement cases that support the determination of an abusive act, and continue to monitor developments in this space. Financial institutions should also ensure that their responsible and fair banking programs continue to assess products, services,

processes and practices for potential issues, and initiate appropriate risk mitigation, as necessary.

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