Lender Third-Party Service Provider Liability: Analysis and Timeline

Unprecedented Lender Regulation Triggers a Compliance Age in the Title and Settlement Industry

BY CHRISTOPHER GULOTTA

Lenders, regulators and title underwriters recognize that independent title and settlement agents (ITSAs) play a critical role in the facilitation of mortgage finance transactions. These mostly small and closely-held companies possess the local knowledge, expertise, efficiency and coverage needed to enable consumers, lenders and underwriters to consummate such transactions nationwide, with nearly unlimited scalability, on a daily basis. Beyond ensuring that lenders are primary lien holders, the role of ITSAs requires that they have extensive contact with consumers and lenders, handle highly sensitive non-public personal information (NPI), and receive and disburse huge sums of funds. This requires lenders, consumers and scores of parties involved in such transactions to reach beyond the traditional expertise of ITSAs, and to rely upon their fidelity and adherence to a score of expanding federal and state laws, rules and regulations.

Heightened legal and regulatory compliance requirements are only part of the picture. In addition, leading institutions have become more involved in the regulatory arena, including multiple federal and state regulators, lenders and the American Land Title Association (ALTA). Collectively, these parties aim at rendering the title and settlement process safe and sound and ensuring closings are conducted in a manner that best protects consumers. ALTA's Best Practices provide ITSAs with a tangible list of critical criteria that endeavors to reconcile all regulatory sources and industry mandates.

Yet there are some tensions and conflicting goals among the stakeholders, which create industry uncertainty over how to best adapt to and embrace this rising compliance expectation. For example, the Office of the Comptroller of the Currency (OCC) and the Consumer Financial Protection Bureau (CFPB) have differing regulatory objectives. While both regulators make clear that lenders are responsible for all the vendors in their supply chain, the OCC requires lenders to act in a safe and sound manner, whereas the CFPB requires lenders to act in a manner that provides consumer protection in the context of consumer financial laws. These seemingly consistent goals can, in operation, sometimes conflict. (For example, a consumer's right to select vendors can conflict with the safety and soundness of the closing process.) Moreover, the operative guidance these regulators provide was designed to be "flexible" or discretionary. In effect, this leaves lenders with the sword of Damocles hanging overhead when trying to determine how to implement, scale and push down these mandates to an industry that varies in practice from state to state and often county to county.

Understandably, lenders are struggling to determine how to implement these mandates, given the lack of a uniform, national consistency regarding closing practices and the roles of ITSAs. Lenders also grapple with how, if at all, to scale-down such requirements and how to determine what precisely is "appropriate" in each circumstance and in each closing locality.

In the absence of a uniform, consistent guideline for compliance, a concrete timeline and a clear understanding of what is expected of

ITSAs, an implementation ambiguity exists at a time when all should be moving forward.

So what are ITSAs to do? Fortunately, for such companies, ALTA created and charged a task force with developing a list of the most essential categories of compliance. In fact, ALTA went further by meeting with the principal stakeholders—including lenders, regulators, underwriters and agents—to produce the seven pillars of its "Title Insurance and Settlement Company Best Practices." The association created the Assessment and Certification processes to be as robust and consistent as possible with what such stakeholders and the industry deem most appropriate moving forward into the emerging *Compliance Age* of our industry.

Throughout the following chronology of operative regulatory guidelines, rules and bulletins, the various regulatory agencies emphasize and generally are in agreement on the following key points and expectations regarding lenders' risk management of their third-party service providers:

- **Lenders are responsible for their third-party service providers:** A lender's use of service providers does not diminish its responsibility to ensure that all related activities are conducted in a safe and sound manner, consistent with applicable laws and regulations. In fact, service providers are subject to the same risk management, consumer protection and privacy obligations that would be expected if the lender were conducting the activities directly. Service providers are also subject to the same regulatory oversight and scrutiny as lenders.
- **Reliance on third-party relationships can significantly increase a lender's risk profile:** In particular, a **lender's strategic, reputation, compliance and transaction risks** are all heightened by the use of third-party service providers.
- **To control this risk, lenders should adopt a risk management process (RADDCO):** A risk-management process should include: (a) A ***risk assessment*** to identify the lender's needs and requirements; (b) proper ***due diligence*** to identify and select third-party service providers; (c) written ***contracts*** that outline duties, obligations and responsibilities of the parties involved; and (d) ongoing ***oversight*** (monitoring) of the third parties and third-party activities.
- **Lenders have flexibility in their oversight of third-party service providers:** A lender's risk-management system should reflect the complexity of its third-party service provider activities and the overall level of risk involved. Each lender's risk profile is unique and requires a tailored risk mitigation approach appropriate for the scale of its particular third-party relationships, the risks present and the ability of the lender to manage those risks. Thus, no single system is ideal for every lender or circumstance.

Timeline Summary

July 2001: The OCC releases "Interagency Guidelines Establishing Standards for Safeguarding Customer Information" (12 CFR § 30, Appendix B). The OCC ensures that national banks and federal savings associations operate in a safe and sound manner and in compliance with applicable laws. In these guidelines, the OCC advises that a lender, in fulfilling its oversight obligations, should: (a) exercise appropriate due diligence in selecting its service providers; (b) enter into contracts requiring service providers to implement appropriate measures to meet the objectives of the guidelines; and (c) monitor its service providers to confirm they are implementing the agreed-upon security measures. As part of this monitoring, a lender should review audits, summaries of test results or other equivalent evaluations of its service providers.

November 2001: The OCC releases Bulletin 2001-47, "Third-Party Relationships: Risk Management Principles." Providing further guidance to lenders on managing risks that may arise from their business relationships with third parties, this bulletin highlights four key requirements of a lender's risk management process: (a) risk assessments to identify the lender's needs and requirements; (b) proper due diligence to identify and select third-party service providers; (c) written contracts outlining duties, obligations and responsibilities of the parties involved; and (d) ongoing oversight of the third parties and third-party activities.

June 2008: The Federal Deposit Insurance Corporation (FDIC) releases Bulletin FIL-44-2008, "Guidance for Managing Third-Party Risk." This bulletin and the supporting financial institution letter describe potential benefits and risks arising from third-party relationships and outline risk management principles for a lender's significant third-party relationships.

March 2012: The five largest mortgage servicers enter into consent judgments. The Justice Department, HUD and 49 state attorneys general announce the filing of their landmark $25 billion agreement with the nation's five largest mortgage servicers to resolve violations of state and federal law. The agreement provides for "new servicing standards" that mortgage servicers are required to implement. Servicers are required to oversee and manage third-party relationships in which they must perform due diligence and conduct reviews to ensure viability. Servicers must also conduct audits of third-party providers to ensure compliance with applicable state and federal law and that servicers regularly review and assess the adequacy of the internal controls and procedures of their third-party providers

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April 2012: The CFPB releases Bulletin 2012-03, "Service Providers." This bulletin makes clear that the CFPB expects supervised banks and nonbanks to oversee their business relationships with service providers in a manner that ensures consumer protection through compliance with federal consumer financial law. Specifically, the CFPB expects lender banks to have "an effective process for managing the risks of service provider relationships." Lender banks should: (a) conduct thorough due diligence to verify that each service provider understands and is capable of compliance; (b) review the policies, procedures, internal controls and training materials of service providers to ensure that the service provider conducts appropriate training and oversight of employees; (c) include in service provider contracts clear expectations about compliance, as well as appropriate and enforceable consequences for violating any compliance-related responsibilities; (d) establish internal controls and on-going monitoring to determine whether each service provider is complying with the law; and (e) take prompt action to address any problems identified through the monitoring process, including terminating the relationship where appropriate.

October 2013: The OCC releases Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance." This bulletin replaces and rescinds Bulletin 2001-47 and raises the compliance bar for banks in the context of their management of third-party relationships. The OCC raises concern that banks may generally have "failed to" assess the risks associated with third-party providers, perform due diligence and on-going monitoring of these relationships, and enter into agreements properly assessing internal risk management capabilities. The OCC now expects "more comprehensive and rigorous oversight and management of third-party relationships that involve critical activities [including] significant bank functions (e.g., payments, clearing, ***settlements***, custody)." This heightened expectation places banks and ITSAs even more squarely in the regulatory cross-hairs.

If this mounting regulatory concern and effort to identify the risks associated with the use of service providers were not enough, consider how the largest mortgage lender has recently weighed in on this. In a newsletter to its settlement agents, Wells Fargo makes clear that as third-party compliance expectations increase, so too will Wells' expectations of its service providers, through increased monitoring and performance metrics. The lender said it supports ALTA's Best Practices and identifies a "transition time" to become a compliance "top performer." Wells inquires into whether the implementation process has begun and whether ITSAs are able to document and validate it independently.

In conclusion, while we do not have a uniform template or a hard timeline for compliance, a True North for ITSAs is clearly to work diligently to document and demonstrate compliance with ALTA's Best Practices. Doing so will help ensure a company is well-positioned to withstand lender or regulator scrutiny and that it is able to tangibly demonstrate and market precisely what the up-stream referral sources will now require. ■

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