Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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Circuit Court Challenges Controversial 2010 Mortgage Loan Officer Ruling

In 2010, a Labor Department ruling on mortgage loan officers and overtime pay gave bankers a giant headache. Now, a federal appeals court ruling may deliver the aspirin.

The U.S. Court of Appeals for the D.C. Circuit this month ruled that the DOL did not comply with the Administrative Procedures Act when it issued that controversial 2010 ruling – and ordered that it be vacated.

Ultimately, the ruling could end up giving banks some new latitude in how they classify and pay loan officers. Unless the decision is reversed on appeal, the ruling means, at least, that banks and trade groups will have a chance to have input if the agency tries to revive its employee-friendly interpretation. For now, banking lawyers said banks should proceed cautiously.

"I would say at this point employers of mortgage loan officers are left scratching their heads saying, 'What is the rule? What am I supposed to do,'" says Brian Pedrow, a labor lawyer with Ballard Spahr. "The conservative, prudent approach would be to take a wait-and-see attitude, leave the mortgage loan officers classified as non-exempt, entitled to overtime, which is the classification you

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Prepaid Cards, a New Front in Third-Party Due Diligence Scrutiny?

Consumers have developed an appetite for prepaid cards and community banks want a piece of the growing pie. But regulators are starting to push back, taking aim at institutions and their non-bank partners.

First California Bank ($1.8B) in Westlake Village, Calif., and an affiliated prepaid card provider, recently agreed to pay fines and restitution of over $1.7 million for how they marketed and serviced a prepaid reloadable MasterCard. The FDIC had accused First California and its partner, Achieve Financial Services, an Austin, Tex., firm, of engaging in unfair and deceptive practices in violation of Section 5 of the FTC Act.

And last year the OCC found "violations of law and regulations and unsafe and unsound banking practices related to vendor management practices" by Florida-based Urban Trust Bank ($640 million), for issuing a prepaid card with credit features that was allegedly used to evade state payday and usury laws.

The situation shows how bank regulators are ramping up scrutiny of third-party vendors, and imposing growing obligations on banks to better manage those relationships. They are obtaining consent orders from the banks and their third-party service providers, often under the aegis of fair-lending laws.

And more regulation may be on the way. The CFPB, in its spring 2013

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Community Bankers Weak on Contingency Funding Plans, Fed Says

Are you ready for a liquidity crisis? Regulators don't seem to think so.

A recent article by a Federal Reserve official makes the case for banks having a strong Contingency Funding Plan (CFP). It also suggests that community banks have fallen short in their efforts to formulate and implement CFPs in recent years.

"Poor liquidity management … can sink the bank quickly with only a small push in the wrong direction," observes author Rachel Bryant, a capital markets examiner for the Federal Reserve Bank of Atlanta. "A CFP is valuable because the acts of building and maintaining it provide a continually updated risk assessment tool in addition to a crisis control guide."

All financial institutions, regardless of size and complexity, Bryan notes, are required to have a formal CFP that sets out strategies for addressing

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Prepaid Cards a New Front

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regulatory agenda published this month, indicated that, by December, it intends to propose a rule regarding general purpose reloadable or GPR prepaid cards. The agency held extensive field hearings on the issue, and is under pressure from consumer groups, who see the cards as unfairly targeting unbanked consumers and people who have credit problems.

"The regulators have begun looking at the prepaid card providers as an extension of the issuing banks' business, and so when it comes to questions of safety and soundness and regulatory compliance, they are now saying to the banks, "You need to make sure you know that these guys are complying with all the laws that they are supposed to,'" said Ben Jackson, senior analyst and prepaid card expert for Mercator Advisory Group, Maynard, MA. "The regulators are saying, 'You have to take your internal compliance program and extend that to your partners.'"

In the case of First California Bank, the FDIC cited misrepresentations and omissions on Achieve's website that it considers deceptive, such as advertising free online bill pay, promoting certain features and services of the AchieveCard that were not available to cardholders, and charging fees that were not clearly disclosed. Achieve's error resolution procedures imposed additional, undisclosed requirements on cardholders, the agency alleged.

The bank, without denying or admitting guilt, was ordered to correct all violations of law, establish a compliance management system to address consumer protection risks, ensure better oversight of third-party activities and reevaluate the effectiveness of its audit program, among other requirements. FCB, which is being acquired by PacWest Bancorp, has reportedly said in regulatory filings that it plans to wind down the division that runs the prepaid card program.

One clear area of concern, experts say, are rent-a-bin or sponsorship arrangement where regulators perceive that a bank is simply renting its charter to permit a third party to avoid state laws or to take advantage of the bank's membership in the card networks.

"It's quite clear based on some of the recent enforcement activity that the days of rent-a-bin are long over and, regardless of the bank's revenue share from a program and indemnification rights against its third party service providers, banks are ultimately responsible for their programs and the service providers who facilitate these programs," says Amy Ross Lauck, a banking partner with Lindquist & Vennum in Sioux Falls, S.D.

Regulators also seem to be targeting prepaid card programs and banks' relationships with third parties that they perceive as higher risk. One example: GPR cards that can be obtained online or through a program manager or distributor that is affiliated with a check casher, payday lender or tax preparer.

"While they aren't outright prohibiting these types of programs, if an issuer intends to offer these types of programs, they need to be proactive in developing a compliance management program that adequately addresses some of the unique money laundering, consumer protection, reputation and compliance risks associated with these types of programs and third party relationships," Lauck said.

The OCC agreement with Urban Trust Bank involved a prepaid card that was managed by Insight Card Services, through Community Choice Financial, Inc., which operates a chain of payday loan stores under the CheckSmart name and other names. Consumer groups alleged that the card was intended to evade the Arizona usury cap that went into effect in 2010. The prepaid cards offered a line of credit that critics said had an effective annual rate of 400%.

OCC required the bank to prepare a written analysis of the prepaid debit card program that includes an assessment of the bank's controls, policies or procedures, MIS and oversight of the prepaid debit-card operation, including risk-management principles commensurate with the complexity of its third-party activities and the overall risks involved.

Experts said having policies and procedures in place will do little to satisfy regulators if you are doing little or nothing to employ or enforce them. Banks should have robust third party risk and compliance management programs in place to manage their prepaid programs and service providers.

Lauck advises banks to:

- Tailor programs to address the specific risks associated with the types of prepaid programs and third parties that you are using.
- Ensure that risk and compliance management programs address the specific requirements set forth in the June 2011 OCC risk management guidance for prepaid programs. Issuers would be wise to comply with the guidance regardless of their regulator.
- Address all four pillars of third-party oversight including initial and periodic risk assessments, due diligence reviews, detailed contract structuring and continuing oversight of significant third party relationships.
- Address in detailed policies and procedures compliance requirements and risks associated with prepaid programs and adequately train employees and third-party servicers on these policies and procedures.
- Maintain a robust audit program to identify compliance violations or potential violations and remediate these issues as soon as possible.

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"The most import thing for banks is to make sure that the parties involved in producing the prepaid card program are doing what they need to do to be compliant," said Jackson. "The bank needs to make sure that everybody is in compliance, and not just take their partner's word for it. It involves a little more work, but it will be worth it in the long run."

"Banks should look at the marketing materials, the disclosures and the fee structures, and think about whether or not that would pass muster if that were in their own branches," he said, adding that a bank would do well to consider, "If this were a card that the bank were offering on its own, would that be a product that it would gladly put its name on and market?" ■

Contingency Funding

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liquidity shortfalls in emergencies.

Regulators are increasingly concerned about the impact of rising interest rates on balance sheets, and, experts say, the article is a not-so-subtle warning to community banks to get their acts together sooner rather than later.

"This article was a shot across the bow," said Ron Riggins, president of RP Financial LLC, Arlington, Va., adding that while many community banks may have broad CFP policies in place, they have not thought out the core elements, such as scenario planning, rigorous stress testing, internal management and reporting. "Management teams need to be better prepared to respond to the fire alarm. Everything happens so quickly. There needs to be clear lines of roles and responsibilities, triggers, authorization levels, technical reporting to management. All those need to be very well thought out. I don't think that we have seen that comprehensively across the community banks."

Don't be surprised if this issue climbs the list of examiner priorities, Riggins says. "I do think the regulators are very concerned about this," he adds. "I would say this is perhaps one of the new hot spots, and I think we may see a lot more enforcement actions that come as a result."

In the article, titled "Contingency Funding Plan: Banking Busywork or Essential Management Tool?" published in the latest issue of *Community Banking Connections*, Bryant said that the Fed sees the CFP "both as a risk management

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Contingency Planning

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document and a regular deep dive into the bank's liquidity profile."

With descriptive roles, responsibilities and action plans, a CFP prepares management to execute a controlled response to unforeseen stresses, she said, adding that by also incorporating scenario analyses and stress testing, it can help a bank identify and head off an undesirable liquidity position before a crisis hits.

"A CFP uncovers cross-exposures, funding concentrations, and operational strengths and weaknesses, which are beneficial pieces of information in any environment," she wrote.

The document should include numerical projections as well as a narrative that helps employees understand their roles in a stressed environment. "Projections are important," she says, "but so is the step-by-step process for carrying out the projections."

"A CFP is like a GPS for liquidity," says Matt Pieniazek, president of Darling Consulting Group, Newburyport, Mass. "It helps you see from 30,000 feet where you are, where you are headed and what are the potential road blocks and trouble spots ahead."

"What banks have to start thinking about now is the next economic growth cycle," he said. "It is quite possible that many banks will be faced with the following scenario when that occurs: significant increase in credit demands and draws on lines at the same time substantial deposits exit to be deployed into businesses and a myriad of other investment alternatives. Banks need to develop a clearer understanding of the dynamics of that potential outcome now."

Here are the major elements of a CFP as Bryant reported them:

- **Roles & Responsibilities**. The CFP should span the full institution and provide for a comprehensive crisis management team with clearly defined roles. Action plans and the assignment of responsibility for carrying out the plans should be realistic and formalized in writing.
- **Contingent Liquidity Sources**. All material contingent liquidity sources should be identified including the order in which the alternatives will be pursued. Ensure that legal agreements with sources that require advance notice such as the FHLB and the discount window are in place. Address potential barriers in accessing funding alternatives such as the impact of pledged assets approaching maximum levels or of collateral calls that reflect the reduced value of pledged assets.

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The CFP should not assume that all contingent liquidity will come from one source. Funding diversification is not only a worthy goal but is also a forced outcome in a crisis because liquidity pressures tend to spread from one funding source to others. The CFPB document should discuss multiple funding options and avoid undue concentrations.

- **Scenario Analysis.** Consider a range of events. Include short-, intermediate- and long-term scenarios as well as idiosyncratic and market-wide events. Liquidity risk is not limited to the possibility of a five-day run on the bank; rather, liquidity stress can span many months and take many forms. Bank management should consider events that best reflect the institution's business activities, operations and liquidity risk exposures. Include scenarios required under SR Letter 10-6 including losing well-capitalized status and having to meet prompt corrective action limits.

"The purpose of this exercise is not to create a numerical prophecy of exactly what a contingency event will look like and exactly how assets and liabilities will be affected to the dollar. There are many possible stress scenarios, but the CFP projects only a tiny subset of this universe," Bryant wrote. "Scenario analysis is worthwhile because it requires management to go through the steps of considering how each asset and liability might behave in a disruption."

A weakness of such plans, experts say, is that banks often do not consider especially dire scenarios out of fear that examiners assume the banks really expect those scenarios to pan out. The alternative – focusing on plain vanilla or only likely outcomes – misses the point, however.

"It is important that banks understand that these tools are not intended to be used against them by regulators," Pieniazek says. "The regulators are looking to see if banks are being sufficiently robust in terms of what could cause a crisis, what could stress them, and if it were to manifest itself, how quickly and to what extent a liquidity crisis could materialize."

Contradictory assumptions, Bryant says, are another source of weakness in otherwise healthy CFPs. Assumptions should be mutually supportive. To wit: if the scenario simulates a reputational crisis projections should not assume an increase in core deposits. If the bank loses its well-capitalized status, brokered deposit assumptions should not be made as PCA rules do not exist.

• **Triggers**. Early warning indicators are crucial in monitoring potential liquidity problems and enacting the CFP in a timely manner. Triggers should operate like a stoplight. Changing conditions trigger "yellow" warning signals and prompt appropriate mitigating actions. If conditions worsen, indicators move into the "red" status, prompting further mitigation. Predetermined and objective triggers avoid the possibility that the CFP will be implemented too late.

Triggers can vary widely from bank to bank, and may trigger different responses within a bank, Riggins points out. A 5% drop in cash flow may not trigger a full-bore CFP implementation, but it might be cause to alert certain personnel to monitor the situation and be prepared to take more drastic action if the drop hits 10%. "It becomes a kind of dress rehearsal," he says.

Deposit withdrawals could be another trigger. "There are a lot of things that have to be evaluated. Is there something external or seasonal? Is there an aggressive new competitor?" Riggins says. "But if you are just looking at normal deposit withdrawals, and if that number suddenly increases significantly or if you have an increased number of closed accounts, those types of triggers again put up a red flag, and the defensive strategy should begin at that point."

• **Reporting**. The CFP should describe the type and frequency of reports that will be delivered to key personnel in a crisis. Management should have the ability to increase the frequency of liquidity reporting quickly if a stressful event occurs. Without swift and responsive reporting, management may not fully know how a liquidity crisis is affecting the institution.

• Updating and Maintaining. CFP – like a business continuity plan – should be revisited regularly. Directors should understand and review, at least annually, the full CFP with the stipulation that certain conditions may warrant more frequent review. Management should periodically test the operational components of the CFP, and consider enacting the full plan in a practice drill. While the bank cannot test the liquidation of assets, it can test the operational process for liquidating the assets, or ensure that contingent liquidity lines have been established and are quickly accessible. Some circumstances may warrant unscheduled testing if, for example, management can feel the rumblings of an impeding economic disturbance.

"Testing may conclude with results that are not pretty. Ultimately the purpose of testing is to uncover weaknesses, holes or inefficiencies so that any glitches may be addressed forthrightly," Bryant said.

Riggins says banks need to be forthright in acknowledging the risks in the current economy. "Everybody has become complacent, almost not anticipating that there could be a quick rise in rates. That is my primary concern," he says. There are a lot of factors that can stress an institution's liquidity. There can be downgrades in loans because loans are not performing, changes in ratings of securities. These things are significant. But I think the biggest factor right now is what happens if we do have a fairly sharp increase in interest rates."

"Having a comprehensive CFP in place," he adds, "is more critical than perhaps it has been since the early 1980s." ■

Mortgage Loan Officer Ruling

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would have afforded them under the 2010 interpretation. Let everything sit. That way you are not creating exposure for yourself."

While not binding, the DOL position is considered influential, and entitled to deference in cases that go to courts. Whether an employee is classified as exempt from the Fair Labor Standards Act is a highly fact-specific exercise, and depends on employees' individual duties and responsibilities.

In 2006, the DOL, under the Bush Administration, concluded in an opinion letter that mortgage loan officers fell within the "administrative exemption" to the FLSA, and were not entitled to overtime. The agency took the view that loan officers' primary duties involved "servicing the employer's business," by marketing, servicing and promoting financial

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Mortgage Loan Officer Ruling

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products, and exercising discretion and independent judgment by assessing alternatives and making recommendations to the customer.

In 2010, the DOL, under the Obama Administration, abruptly reversed course, issuing an "Administrator's Interpretation" declaring that typical mortgage loan officers act more like salesmen than bona fide administrative employees, and "fall squarely on the production side of the business." Unlike accountants or HR employees, the duties of mortgage loan officers do not relate to the internal management or general business operations of the company, the DOL concluded.

In light of the flip-flop, the Mortgage Bankers Association filed suit against the DOL arguing that the agency could not in effect re-interpret its own rule without giving affected parties notice and a chance to comment. The D.C. federal district court sided with the government; the appeals court reversed, agreeing with MBA, holding that a significant change in the interpretation of a regulation is tantamount to a repeal or amendment of the regulation.

"The D.C. Circuit basically said, 'These interpretations are so intertwined with the regulation itself that if an agency cannot change its regulations without notice and comment from the public why should it be able to change them with an interpretation?" Pedrow said.

The appeals court sent the case back to the district court with instructions to vacate the 2010 interpretation. The legal status of the 2006 opinion is unclear since the 2010 interpretation explicitly withdrew it. The court left open the possibility of DOL conducting the required notice and comment rulemaking to implement the change. "If the Department of Labor wishes to readopt the later-in-time interpretation, it is free to. We take no position on the merits of their interpretation. DOL must, however, conduct the required notice and comment rulemaking," the court said.

In the wake of the 2010 interpretation – and the substantial statutory penalties that employers face for violating the overtime rules – many lending institutions began adopting the safer approach, paying mortgage loan officers overtime or else limiting them to 40-hour weeks. Aside from the administrative exemption, the FSLA provides for a separate overtime exemption for sales personnel who operate primarily outside the office, which banks have also been using.

The overtime issue has landed many banks and lenders in court. In 2011, a U.S. district court jury in Detroit found that 400 Quicken Loan mortgage loan officers seeking overtime were covered by the administrative exemption. The plaintiffs' attorneys in the case – encouraged by the 2010 DOL interpretation – had argued that the employees were not exempt because they were essentially sales workers and not true administrative employees involved in the general management or operations of the company. The case was seen as unusual because Quicken Loans had already modified the manner in which it compensated loan officers to provide for payment of overtime. The verdict was upheld last year by a federal appeals court in Cincinnati.

Banking lawyers noted that, ultimately, the proper classification of an employee is a case-by-case determination. What's more, they noted that improperly classifying an employee could be construed by regulators as an unsafe and unsound banking practice.

"The exempt status of any employee is determined by whether the employee's salary and duties meet the requirements of the regulations," observed a recent analysis of the DOL case by Dickinson, Mackaman, Tyler & Hagen, a Des Moines law firm. "Any generalization, especially based on title alone – even a generalization of the sort found in the DOL's soon-to-be-reinstated Opinion Letter FLSA 2006-31 – is dangerous. Instead, one always needs to look at what an employee is actually doing."

"Our advice to clients is, 'Know this could be evolving, that it is out there, and watch it closely," says Allyn Dixon, a banking specialist at the firm. "Your human resources' people should have good job description that fits these people in the proper classification. Focus on duties. Focus on tasks. It has to be on a case-by-case basis, how they operate in the organization." ■