

Consumer Lending: Time to fine tune collection efforts

Regulators keen to
avoid parallels to mortgage servicing
problems

In spite of the letter
files above, mishandling consumer loan collections increasingly spells
"t-r-o-u-b-l-e."

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While the mortgage industry and its struggle to cope with a still stubbornly high number of foreclosures continues to grab news headlines, another area of financial services has emerged with its own default servicing challenges--consumer lending. Although financial institutions might not be as focused on the severity of this growing issue, the Consumer Financial Protection Bureau is clearly paying attention.

Estimates indicate that 23 million automobile, credit card accounts, and personal and business loans, worth an estimated \$278 billion, are non-current. Then, there is the ongoing issue with student loan debt, which has far surpassed all other consumer debt. With more than \$1 trillion in outstanding student loan debt, it is not surprising that CFPB has handled thousands of complaints from private student loan borrowers during 2012.

"The issues student loan borrowers are encountering bear an uncanny resemblance to the problematic practices uncovered in the mortgage servicing business," Rohit Chopra, CFPB's student loan ombudsman.

As a result, servicing and default practices for consumer lending are high on CFPB's radar right now, with particular focus on credit card and student loan debt. In October 2012 CFPB announced that it would also begin overseeing the largest nonbank debt collection firms--those with more than \$10 million in annual receipts--in January 2013. CFPB plans to apply lessons learned from the mortgage market crash to help drive reform in the consumer lending space. As such, industry experts anticipate that over the next two years consumer default servicing will be as highly regulated and monitored as mortgage servicing.

Regulators take aim
at consumer default issues

The nation's largest financial institutions have been accused of selling delinquent credit card accounts to collection agencies and law firms without providing adequate or even accurate documentation to corroborate the amounts they claimed were past due. As a result of a regulatory probe by the Office of the Comptroller of the Currency in 2011, several

institutions halted their credit card collection operations--resulting in billions of dollars of lost revenue.

Another way financial institutions try to recoup money is to bring collection suits against debtors. Since most consumers don't show up to court, financial institutions win default judgments in an estimated 95% of the cases. However, when debtors do appear in court with legal representation, they win an overwhelming majority of the cases because of inconsistencies in the lender documentation and recordkeeping. Often, financial institutions sell the debt to third parties without an appropriate audit trail. If the collection agency does not have access to the original creditor's business records or proof as to how the debt was created, they cannot attest to the validity of the debt and will lose in court, if contested.

Additionally, CFPB handled more than 2,900 complaints about private student loans during the first seven months of 2012. More than 30% of these complaints relate to issues borrowers faced when they were unable to make payments, including default, debt collection, and bankruptcy. Private student loan borrowers are struggling with loan terms and conditions and are reportedly having trouble resolving issues with their servicers; and are finding themselves unable to modify repayment terms, even when they cannot afford the payment.

Based on these allegations, the floodgates are now open for government intervention. CFPB and the Comptroller's Office have both put the consumer default servicing market on notice that they are under increased scrutiny.

In addition, regulators are examining how culpable financial institutions should be for wrongful debt collection activity by third parties.

For instance, in April 2012, CFPB announced that financial institutions under bureau supervision might be held responsible for the actions of the service providers they contract with. CFPB aims to protect consumers by holding financial institutions responsible for any errors or misdeeds by third parties and expects financial institutions to have effective risk management processes in place to help manage these relationships.

As such, CFPB recommends that financial institutions not only exercise due diligence when selecting service providers, but also establish internal controls and ongoing monitoring to ensure compliance is not compromised.

CFPB's new focus:
consumer lending protection

While CFPB initially focused much of its effort on the mortgage servicing industry, the regulator's attention is now shifting to consumer lending. As new issues continue to emerge, CFPB is not only carefully studying the consumer lending market, but also actively soliciting feedback directly from consumers regarding their experiences and interactions with financial institutions and collection agencies (for instance, on student loans). CFPB intends to lay a solid foundation and conduct thorough due diligence before officially stepping in.

However, CFPB has stated that it will not always use "formal" regulations when dealing with financial institutions. Pursuant to Dodd-Frank, CFPB's current approach is to issue consent orders when taking action against institutions engaging in unfair, deceptive, or abusive practices. Consent orders help broadcast to other financial institutions what types of actions warrant enforcement from CFPB and encourage an immediate response from organizations to adhere to the specified compliance standards. In

October 2012, CFPB issued an enforcement action against a large credit card company for multiple violations of various laws, including improper debt-collection practices, resulting in a \$85 million consumer refund and a \$27.5 million civil money penalty. [Editor's note: For more about CFPB enforcement actions, see "UDAAP: 5 lessons from CFPB actions," by Lyn Farrell of Treliant Risk Advisors.]

As financial institutions wait for CFPB to issue additional consumer default rules and guidelines, servicers should be proactive in thinking about compliance for the documents and processes they already have in place. Servicers are heavily burdened with having to monitor regulatory and legislative changes, identify, and assemble the numerous compliance documents and disclosures required by state and federal law as well as having these documents sent to, read, and signed by the lender, attorneys, and the delinquent borrowers. Regulators also require servicers to provide proof that those steps were completed, including a full audit trail of any communications with the borrower.

Additionally, traditional servicing platforms simply are not designed to accommodate and/or implement many of the required workflows and compliance content now needed. Disparate systems and procedures can make even relatively simple changes more time-consuming and complex. As a result, some servicers are undertaking the huge task of re-engineering their systems and processes to meet all federal, state, and municipal regulatory requirements. Although this might seem like an overwhelming task, keep in mind the reputational risk that is also inherent to compliance errors.

Staying on top of compliance matters now will protect your bank from government enforcement and poor customer relations.

Prepare now for the
change to come

Not only is today's consumer lending environment characterized by constant change, but also tougher enforcement. While issues with larger financial institutions and debt collection agencies are receiving much of CFPB's attention right now, all organizations with consumer default servicing operations should be on alert.

Faced with large volumes of delinquent consumer loans--and with many more on the way--financial institutions are running out of resources. The largest financial institutions are already using hundreds of law firms across the U.S. to help manage ongoing compliance issues. Many financial institutions are turning to outsourcing providers to help from a capacity and compliance standpoint. One of the best ways to achieve operational efficiency may be to outsource the tasks that are too resource and/or time intensive, enabling financial institutions to mitigate risk in the most cost-effective manner while ensuring their compliance programs will withstand any scrutiny from CFPB.

CFPB has made no secret of its plans to hold financial institutions and debt collectors more accountable for their actions. While organizations are left to speculate what exactly that means, a little preparation now will go a long way in making the transition easier when CFPB's formal regulations are finally released.

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