Evaluating Impact of Consumer Harm

Introduction

The FDIC has a risk-focused consumer compliance examination approach, based on the potential for compliance errors to have an adverse impact on banking customers. The following guidance is provided to assist compliance examiners in understanding the impact of consumer harm[1] on examination and supervisory responsibilities. In addition, this guidance communicates to examiners information about bank activities or omissions that can frequently result in consumer harm. Examination activities promote and confirm FDIC-supervised institutions' compliance with federal consumer protection laws, fair lending statutes, the Community Reinvestment Act, and the regulations that implement these requirements. Effective supervision focuses on the areas requiring elevated supervisory attention and promotes the efficient use of resources.

What is Consumer Harm?

The FDIC's consumer compliance examination process is risk-focused based on the potential for consumer harm. "Consumer Harm" is an actual or potential injury or loss to a consumer, whether such injury or loss is economically quantifiable (e.g., overcharge) or non-quantifiable (e.g., discouragement). It may be caused by a financial institution's violation of a federal consumer protection law or regulation, a disregard for supervisory guidance, or a wrongful act by a financial institution or by a third party. Consumer Harm may occur in a variety of ways, including:

1. **Quantifiable harm** – Economic harm to a consumer where the injury or loss can be measured. For example, a consumer may suffer monetary harm as a result of deceptive marketing practices that entices a consumer to purchase a product without having accurate information regarding the benefits, costs, or terms of the product in violation of Section 5 of the Federal Trade Commission Act. Similarly, if a bank employs a pricing structure that allows significant discretion, without effective monitoring or controls, resulting in a protected class of borrowers being charged higher prices on average than similarly situated non-protected borrowers in violation of the Equal Credit Opportunity Act, then the higher prices paid by the protected class of borrowers over similarly situated non-protected borrowers is quantifiable consumer harm.

2. **Non-quantifiable harm** – Injury or loss to the consumer that cannot be measured, or is very difficult to measure, yet the consumer may suffer some form of economic or other harm. For example, a consumer could be injured economically when a financial institution unfairly denies the consumer credit or discourages an application on a prohibited basis in violation of the Equal Credit Opportunity Act, however calculating a monetary value for the injury may be challenging. Another example may be a bank that imposes additional, unlawful requirements on consumers before the bank is willing to consider the consumers' billing disputes or requirements that are not accurately divulged in the bank's error resolution disclosures. The practices could discourage a consumer from filing a dispute. Consumer harm exists, but may be difficult to identify and/or quantify.

3. ***Potential harm*** – Involves financial institution activities (or failure to take action) that create the possibility that a consumer may be harmed. An example of potential consumer harm is a violation of the regulations that implement the National Flood Insurance Act of 1968 where the financial institution failed to require flood insurance on a residence at loan closing. The consumer has not suffered actual loss but is exposed to potential economic loss should a flood occur.

Consumer harm is a broad concept and the examples provided here are not exhaustive. Among key points are that consumer harm is not limited to monetary loss, can be quantifiable or non-quantifiable, can be actual harm or potential harm, and may be caused by activities conducted through third-party relationships.

How does Consumer Harm Impact Examination Activities?

The concept of consumer harm is an important consideration in all examination and enforcement efforts, including examination strategies, examination scoping activities, assessment of the CMS, content of examination reports, supervisory actions, and communications with bankers. The FDIC's mission of promoting public confidence in the financial system is best served through a supervisory approach focused on identifying, addressing, and preventing consumer harm.

- *Identification* – Supervisory and examination activities are driven by a focus on identifying the inherent risk of consumer harm that may occur in a financial institution's business activity. Inherent risk is the compliance risk associated with product and service offerings, practices, or other activities that could directly or indirectly result in significant consumer harm or noncompliance with consumer protection rules and regulations. For example, a new loan product, a change to deposit account terms, or a third party relationship all represent inherent risk.

[1] Regarding Consumer Harm as discussed in this manual, "consumers" include persons, as well as commercial customers (e.g., corporations, partnerships, trusts, etc.) which may be eligible for protections under certain laws and regulations (e.g., Section 5 of the FTC Act, the Flood Act, ECOA, etc.). "Consumer Harm" is an actual or potential injury or loss to these consumers, whether such injury or loss is economically quantifiable (e.g., an overcharge) or non-quantifiable (e.g., discouragement).

- *Addressing identified risks* – When inherent risks of consumer harm are identified, examiners will ensure the institution takes appropriate action to address or mitigate these risks. Corrective action for violations of law and regulations should remediate consumer harm when it occurs and remove underlying incentives to engage in practices harmful to consumers. Where there is a violation of law or regulation, the extent and severity of consumer harm informs the type and scope of enforcement action sought to correct the violation.

- *Prevention* –Mitigating factors are the strength of the compliance management system (CMS) to mitigate inherent risk. Examples of mitigating factors include strong management controls, effective training programs, and on-going monitoring efforts. Supervisory efforts should encourage institutions to have an effective CMS to avoid and mitigate risks of consumer harm. To support that effort, examination and other staff communicate information and best practices in a variety of settings to assist institutions in managing risks of consumer harm when conducting their business. Identifying, addressing, and preventing consumer harm is an important consideration in all examination and enforcement activities, as identified in the following diagram and discussed below.

Supervisory Strategies

The FDIC's supervisory strategies are designed to promote compliance with consumer protection laws and regulations in FDIC-supervised institutions. Activities used to implement FDIC supervisory strategies include examinations, targeted reviews, visitations, investigations, and offsite analysis of how the bank manages its consumer compliance responsibilities. The timing and frequency of these activities can be adjusted based upon indications of risk of consumer harm, such as consumer complaints, referral from other divisions or agencies, changes in the institutions' products, services, or markets, or reliance on third parties to offer products and services to consumers. Supervisory strategies should be flexible to respond to indications of increasing or decreasing risk of consumer harm.

Examination Scoping Activities

All applicable federal consumer compliance laws and regulations are considered in connection with any bank compliance examination through the risk scoping process. However, the FDIC's supervisory approach apportions resources to areas of higher risk for consumer harm rather than to uncovering technical issues in meeting regulatory requirements. This approach also results in the identification of the most serious violations of federal consumer compliance laws and regulations during the examination. If financial institutions understand the potential for consumer harm and choose to develop and implement institution-specific plans, policies, and processes to prevent and mitigate consumer harm based on their risk profiles, it may assist institutions in avoiding risk and promoting compliance with the federal consumer protection regulations.

Examiners have several tools available to assist them in identifying risks of consumer harm. Examiners evaluate risks of consumer harm through an analysis of an institution's historical CMS, the products and services currently offered, the markets served, and existing and new third-party relationships. Examiner judgment is the most critical aspect of properly evaluating an institution's risk profile. The FDIC's approach tailors the examination to focus primarily on those areas that present the highest risk of consumer harm, as examiners are unable to review all aspects of an institution's CMS at any given examination. The pre-examination planning process, which includes review of the pre-exam questionnaire with bank management and preparation of the automated Compliance Information and Document Request (CIDR), guides examiners in requesting the information necessary to identify areas of the greatest risk of potential consumer harm.

In scoping examinations, examiners consider the inherent risks associated with product and service offerings or other activities that could directly or indirectly result in consumer harm. Inherent risk refers to the risk that a product, service, practice, or other activity would pose if no controls or other mitigating factors were in place. Examiners also focus on whether a bank is effectively and independently managing or

mitigating the risk of consumer harm that comes from the products and services the institution offers and markets in which they serve. After considering an institution's inherent risks, and the strength of its CMS, residual risk exposure may remain. Residual risk refers to the risk exposure that remains after identifying the level of inherent risk and factoring in the strength of the mitigating factors to control that risk. The guiding principle is a risk scoping formula: inherent risk – mitigating factors = residual risk. For example, a bank introduces a new overdraft program with no due diligence, no monitoring or auditing, and numerous customer inquiries. This example represents a high risk product without effective CMS elements to mitigate inherent risk; therefore, a higher level of residual risk remains, and this product warrants review and transaction testing during an examination. As part of the examination scoping process, examiners focus on areas where residual risk is elevated and not on areas where risk is well-controlled and residual risk of consumer harm is low.

Examination Procedures

Examination procedures are drafted and implemented in a manner to guide examiners in assessing the risk of consumer harm in the conduct of the examination. Well-crafted examination procedures that are focused on risks and potential for consumer harm promote the efficient use of resources, identification of root causes of deficiencies, and allocation of resources to areas presenting the highest risk, while avoiding unnecessary review of areas with little or no risk of consumer harm. As an example, examination procedures regarding overdraft programs differentiate the type and extent of review based on the type of overdraft program offered (e.g., automated versus ad hoc) and further reserves more detailed transaction testing to situations where examiners have identified specific risks or weaknesses.

Report Presentation

The Report of Examination plays an important role in communicating the FDIC's assessment of the CMS to the institution. The FDIC classifies violations of federal consumer laws based, in part, on the level of risk of consumer harm. In the event violations are identified in the Report of Examination, this classification process serves to communicate to banks the FDIC's conclusions about the severity, extent, or potential consumer harm caused by the violation. The expectation is that FDIC-supervised institutions will prioritize corrective action and on-going management of their CMS to correct errors and mitigate risks of consumer harm.

Supervisory Actions

Effective supervision includes requiring institutions to take corrective action when weaknesses in the CMS or violations are identified. Appropriate corrective action considers the overall effectiveness of the institution's CMS, the root cause(s) of the deficiencies as well as the extent and impact of consumer harm. When there is a violation of law or regulation that results in consumer harm, the FDIC will seek corrective action, which may include restitution to consumers as part of an appropriate enforcement action. Civil money penalties (CMPs) may also be assessed to sanction an institution or an institution-affiliated party according to the degree of culpability. Other factors examiners consider include intent and severity of the violation of law or regulation, breach of fiduciary duty, and/or whether a practice is unsafe or unsound. CMPs are also assessed to deter future misconduct.

Communication and Technical Assistance

Communication and technical assistance to supervised institutions is an important component of the FDIC's supervisory approach in preventing consumer harm by supporting institutions' efforts to maintain an effective CMS.

Communication is especially important during periods of regulatory change and transition. The FDIC communicates through a number of channels, including national and regional bankers' teleconferences on emerging topics; speaking engagements at national, regional, state, and local conferences and conventions; a web-based regulatory calendar; *Supervisory Insights Journal* articles; regional newsletters; banker and bank director trainings and online technical assistance videos; meetings with industry trade groups; and issuance of guidance through Financial Institution Letters. Communicating the focus of FDIC examination efforts and supervisory priorities through these diverse channels assists bankers in identifying and reviewing key areas of concern and addressing deficiencies promptly, prior to and unrelated to a specific examination activity. In addition, examiners can provide certain types of technical assistance to community bankers during the course of an examination that may enable an institution to reduce the risk of consumer harm in the operation of its business. These communication and technical assistance efforts provide bankers with tools to address issues that may pose risk of consumer harm.