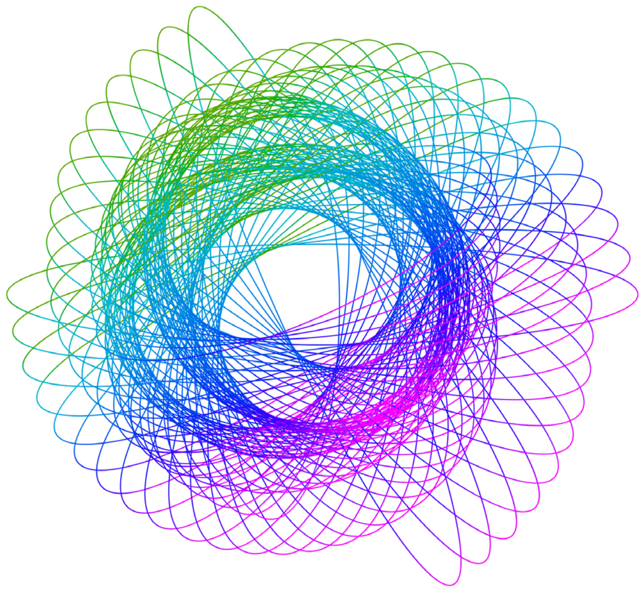

The California Consumer Financial Protection Law and Internal Audit: A new frontier

In preparation for heightened expectations and enforcement of consumer protection issues under a new administration, internal audit (IA) departments of banks and fintech companies need to be aware of the those at both the federal and the state level. Companies engaged in providing financial services and payment solutions to consumers may contend with regulators on two fronts, with California in particular emerging as a presumptive leader for consumer protection. California is poised to bring greater resources to bear in enforcing its consumer protection priorities over financial services and technology companies operating in its jurisdiction via a newly rebranded Department of Financial Protection and Innovation (DFPI) and the *California Consumer Financial Protection Law (CCFPL)*, which became effective January 2021.

Background – Where are we, and how did we get here?

In 2020, California expanded the stature, authority, and capacity of its supervisory oversight and enforcement of consumer protection laws and regulations with a focus on both licensed banking and nonbanking companies, including financial technology (fintech) companies and money services businesses (MSBs).

The DFPI has since been funded and empowered to hire personnel, coordinate with other agencies, and increase their supervisory scrutiny. Additionally, the Conference of State Bank Supervisors (CSBS) has communicated its intent to develop consistent supervisory processes across all states to help oversee and support innovation. At the time, the indication was that the expansion was in response to a believed decrease in enforcement actions and consumer restitution at the federal level by the Consumer Financial Protection Bureau (CFPB).

It is important to note that the CCFPL's subject matter has a degree of overlap with existing federal requirements and priorities. These include unfair, deceptive, or abusive acts or practices (UDAAP) and non-discriminatory access to financial services. The explicit scope of the CCFPL (covered in more detail below) points to where the regulatory crosshairs will likely land. California has invested considerable time and resources to stand up its "mini-CFPB" through the DPFI, and it is likely that stands those resources will be deployed for enforcement, regardless of developments at the federal level.

Scope of the CCFPL – Who is affected?

The scope of the law is expansive. It's coverage arguably includes most financial services firms and providers of payment solutions, including fintech companies and more established technology companies. A subset of financial products or services within the purview of the law include:

- Extending or servicing credit,
- Extending or brokering leases
- Deposit-taking activities
- Transmitting or exchanging funds
- Acting as a custodian of funds
- Providing or issuing stored value or payment instruments (which may include digital wallets and open loop prepaid cards)
- Payments/financial data processing by any technological means
- Consumer reporting activities
- Debt collection

There are a few additional nuances to the scope of the CCFPL:

- A consumer financial product or service may be either "a financial product or service that is delivered, offered, or provided for use by consumers primarily for personal, family, or household purposes" OR a financial product or services covered by the list above
- Covered persons under the law includes any person (and depending on the circumstances, affiliates and services providers) that engages in offering or providing a consumer financial product or service to a resident of California.
- Definitions within the law are intended to be interpreted consistently with the definitions in the ***Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010.*** However, any inconsistency or ambiguity "shall be resolved in favor of greater protections to the consumer and more expansive coverage"

All together, it is clear the CCFPL aims to widen the net of firms, products, and activities that are under the DFPI's purview for oversight and enforcement.

Compliance Considerations – What should IA look out for?

IA departments need to understand how compliance risks from the new law may manifest themselves within their organizations. Key considerations include:

UDAAP – The prohibition of UDAAP is a reference to federal law granting the CFPB the authority to examine for violations of the same. In our experience, the CFPB has traditionally been active in citing UDAAP concerns in both public and non-public enforcement actions. UDAAP has been used, in a manner of speaking, to "plug the holes" where a firm is technically compliant with the provisions of an existing rule, but an act or practice may still be shown to result in (or have the potential for) consumer harm. The DFPI may likely use UDAAP during examinations in the same way.

Discrimination – An explicit purpose of the law is to protect consumers from discrimination in connection with financial practices and services. Discrimination may manifest itself in many forms, both intentional and non-intentional. The concepts of disparate impact and disparate treatment are well known at the federal level due to the Equal Credit Opportunity Act (ECOA) and its implementing Regulation B. The Supreme Court has also considered and upheld the concept of disparate impact in its rulings. A key difference is that ECOA applies to extensions of credit, whereas the CCFPL appears to state a broader goal with regards to the "financial practices and services" it covers. The CCFPL additionally prohibits discrimination against employees or covered persons, bringing enforcement under the DFPI as well. Time will tell how the DFPI will interpret and enforce these provisions.

Complaints – The CCFPL directs the DFPI to establish reasonable procedures to provide a timely response to consumers, to complaints against, or inquiries concerning, a covered person. On the other side of the coin, rules will be written directing covered persons on how to respond to the DFPI regarding a consumer complaint or inquiry. Finally, covered persons must comply with consumer requests for information in a timely manner and include written supporting documentation. As with the CFPB, consumer complaints may take an increased importance at the DFPI and may even help inform the department's examination. Consumer complaint response has long been an important pillar of an effective Compliance Management System (CMS) and will continue to hold its importance in California.

Potential Next Steps – Where does IA go from here?

The independent IA function plays a key role in an objective assessment of risks and controls. The developments in California are a new frontier, however change continues to be the word of the day – with the new presidential administration in its first 100 days, shifting power structures and priorities in the US legislature, and the necessary changes to business-as-usual processes and practices stemming from the pandemic.

Given the current dynamism around consumer protection in California (and at the federal level), there are certain steps that institutions and IA departments can consider to better prepare themselves for the risks ahead.

- **Evaluate and update compliance management programs**, including risk assessments, to better account for the unique consumer protection risks which may have resulted from pandemic-related changes to products/services, operations, and volumes. Fintech companies, MSBs, and other licensed nonbanks should also prepare for increased scrutiny expected from the state regulators.

- **Commence/continue gap assessments over new rules and guidance** relative to people, process, and technology changes. The assessment of the control environment over these areas will drive value by identifying potential control gaps, providing an opportunity to design enhancements to mitigate compliance risk.
- **Revisit the complaints program** and understand if complaint data is appropriately used to drive process improvements, enhance products and services, improve the customer experience, and (importantly) increase compliance. Consumer complaints are often an early warning indicator of a potential compliance issue. This data can be invaluable in identifying and rectifying issues across an enterprise.
- **Stay current with supervisory guidance related to consumer compliance.** The DFPI newsroom contains helpful updates, press releases, monthly bulletins, and important notices for the department's various constituencies. IA departments should also follow the CFPB's quarterly and ad hoc Supervisory Highlights, which will include (among other consumer compliance matters) the risks and issues it identified during the recent Prioritized Assessments, which were inquiries designed to obtain timely information from institutions to assess pandemic-related impacts on consumer financial product markets and identify potential risks to consumers.

Deloitte will continue to follow further developments in this area and will issue additional updates, as appropriate.

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