Consumer Finance Monitor Season 3 Episodes 46: The CFPB's Plan to Reorganize its Supervision, Enforcement, and Fair Lending (SEFL) Division: What it Means for Industry

Speakers: Alan Kaplinsky, James Kim

Alan Kaplinsky:

Welcome to Consumer Finance Monitor Podcast, where we explore important new developments in the consumer financial services industry, issues that are of importance to many of you who follow things in the industry. The name of our podcast show is Consumer Finance Monitor, which you'll recognize is the same name that we use to describe our blog. And our blog has been operational for almost 10 years and a lot of content in there. And the subject that we're going to talk about today we actually blogged about not so long ago. And I'm very pleased to have as my guest today, my partner and colleague, James Kim.

Alan Kaplinsky:

James works out of our Manhattan office, when our Manhattan office is open, which is not right now, but hopefully will be soon. And James joined us after serving a stint in the enforcement division of the Consumer Financial Protection Bureau. And that's what we're going to be talking about today. So before we get to the heart of our podcast show today, a warm welcome to James. I'm delighted that you've joined us.

James Kim:

Thanks, Alan. I appreciate it. And I'm excited to talk about today's topic.

Alan Kaplinsky:

Okay. And so what we're going to talk about today is a fairly recent reorganization of the enforcement area of the CFPB. Well, first, let me ask you first to describe, James, what Kathy Kraninger announced, and then we'll get into some more details about the significance of the announcement.

James Kim:

Sure. So, there hasn't been a public announcement yet. What's happened to date is Brian Schneider, who is the Associate Director in Charge of the entire SEFL division, SEFL standing for supervision enforcement fair lending, he released an internal memorandum announcing the reorganization which is expected to go into effect in the coming months, but may not be finalized for several months. And that memo was obtained by the media and circulated and posted. So it's now public. And so there hasn't been an official announcement from the Bureau, but it is in the public domain and people are talking about it.

Alan Kaplinsky:

And what was in that internal memo, James?

James Kim:

So the primary takeaway is that a new office within SEFL will be created and it will be the SEFL Office of Policy. And it will be headed by Peggy Twohig who is the current head of supervision policy. So, essentially what's happening is they're creating a new office or a new department within SEFL, and it will have consolidated decision making authority and strategic planning authority for all of the SEFL offices.

James Kim:

And as I say it and as people may be listening, they may say to themselves, well, what's the big deal? SEFL is an integrated division that houses supervision, enforcement, fair lending, shouldn't there be a coordinated decision maker, so to speak, for the entire division? And that's very logical. And I think Alan, you and I will talk about why this may be and probably will be a good development for the industry and will streamline, to a certain extent, decision making. But it's still big news because it's a significant change from the status quo, and the status quo has been since the inception of the agency. So for many years now and for the entire history of the CFPB, the status quo has been and currently is that the Office of Enforcement, within SEFL, had the autonomy to initiate its own investigation and send civil investigative demands without approval from outside of the office of enforcement.

James Kim:

With one exception, it's an important one, for supervised entities such as banks over 10 billion, there's always been an extra layer of process before enforcement could investigate a supervised entities such as a larger bank. But upset or setting aside that population of companies, enforcement had a fair amount of autonomy and free reign to investigate who they wanted, but now that's going to change.

Alan Kaplinsky:

James, looking at historically what went on and which will cover the period of time when you were there. So, if as we all know, the CFPB supervises and examines a lot of non-banks, you mentioned the larger banks that they supervise, but they also supervise a lot of non-banks like payday lenders, and companies in the mortgage industry, and a variety of other non-banks. So are you saying that historically, the enforcement area could on its own, without consulting with the folks in supervision, could decide whether or not to pursue an investigation against a supervised non-bank?

James Kim:

I think the clarification is, any supervised entity, so banks over 10 billion and larger market participants subject to the Bureau's supervisory authority, enforcement did not have unilateral authority to investigate them.

Alan Kaplinsky:

Okay.

James Kim:

There was a process where they had to basically, certainly give notice to supervision and give supervision the opportunity to weigh in and I think, in practice, probably block and veto that investigation. Which in the past, not all the time, but sometimes resulted in conflict and dispute between enforcement and supervision about whether or not a supervised entity should be investigated or if the bureau should use the supervisory tool. And so, the word tool is very significant and I'm going to use it quite a bit because that's the vocabulary that's used at the CFPB and I think some other agencies. But specifically today, the CFPB where the debate is often centered around and has been centered around, what's the appropriate tool choice? Is the appropriate tool choice supervision to detect and address issues, or is it investigation through a CIBE and then a public enforcement action?

James Kim:

So, to be clear, in the history of the Bureau to today if the entity, whether a bank or non-bank, but as long as it's supervised, enforcement had to go through a process where there was input and ultimately, perhaps an approval or denial from outside enforcement to start an investigation for a supervised entity.

Alan Kaplinsky:

[crosstalk 00:09:00] Yes. Let me digress for a minute on a somewhat related topic, and that is, there was a reorganization at the bureau I think when the acting director Mick Mulvaney was there, I think it was before Kraninger, of the fair lending area. Fair lending used to also have a lot of autonomy, right? I mean, they could start their own fair lending investigation. I don't know how much approval they obviously needed to go up to the director at that time would have been portrayed to get approval, I would think, before launching an investigation. I'm I right that things changed with fair lending? Fair lending, hasn't happened been moved somewhere else?

James Kim:

I don't think it's moved, it's still an office. It's still housed within the SEFL division. I think some of the reporting lines have changed, but it's still housed within SEFL. I mean, some of the particulars about how it interacted with the other offices I think did change. My view is this recent announcement of shaking up and reorganizing SEFL is bigger and more significant and certainly affects more offices than just fair lending. This is a SEFL wide reorganization that has, in my view, the largest net impact on enforcement as compared to supervision.

Alan Kaplinsky:

So, okay. So now, turning back this change that has not been officially announced yet, but it seems like it's in the works based on that internal memo. So, today or in the future when it becomes effective, if enforcement wants to launch an investigation of a [inaudible 00:11:27], they can investigate small banks, banks under the 50 billion, but they want to investigate a non-bank that's not a supervised entity, a non-supervised entity. They would have to make a recommendation, I guess, to this new office headed by Peggy Twohig, and Peggy would have to approve of the investigation. I've got it right.

James Kim:

Yes. She would have ultimate authority. The details are to be determined. So the memo, at a high level, lays out the roadmap for the new structure, but the particulars of the process, I think, need to be fleshed out. But currently, enforcement staff, enforcement attorneys have to write a memo recommending and making the case for opening an investigation in issuing a CID, and that approval has to come from the director of enforcement. But you're right, in the future, I'm sure there will be some level of approval within the office of enforcement, but the ultimate approval or denial will now come from Peggy and the office that she will hold which will sit outside of and above of enforcement.

Alan Kaplinsky:

So, and just to complete the picture, what role does the director or would the ... Well let's talk first when you were there, would the director have to be involved in the decision to conduct an investigation or only the decision of bring a lawsuit or enter into a consent agreement?

James Kim:

So currently, the director does not need to weigh in. In other words, you don't need director level approval to open an investigation. But based on the memo, that's not going to change. So all of the change is entirely within the SEFL division. So, I think within SEFL, without the directors input, investigations can be open. Again, the key point being, it will no longer be a unilateral decision for enforcement for non-supervised entities, it will come from the new position in the new office that's going to be created.

Alan Kaplinsky:

Okay. And am I right that if enforcement reaches the point where they either want to file a lawsuit or enter into consent agreement, at that point, they've got to get approval of the director. I got that right?

James Kim:

Correct. And I expect that to stay the same going forward.

Alan Kaplinsky:

Right. Okay. So, this change we'll assume that Kathy Kraninger, the director, is behind it. What does it tell you, James, about Kraninger's vision for the bureau. What are you reading into this?

James Kim:

I think it's very consistent with her public remarks since she assumed the office. She has consistently, in her public statements and speeches, talked about, and again, let's use the Bureau's vocabulary, the tools and their toolkit. If we were to prioritize or sequence her preferred sequencing of how she uses the tools, I think education and prevention would be at the top, rulemaking would also be at the top, then supervision, and enforcement is last. So, in her view, enforcement is a last resort only when the other tools are inadequate and you're left with these fairly narrow set of situations where enforcement is necessary to step in.

James Kim:

But, for example, I don't think under her vision and a proposed reorganization, I think it's less likely, I mean, very unlikely that enforcement will be used in the same way that it has been to date, as a diagnostic tool to ascertain whether or not violations have occurred. It'll still need to do some of that for entities that are not supervised, but I think the role of enforcement is going to change, and these proposed changes, I think, align with it very much that the directors remarks to date.

Alan Kaplinsky:

James, what has been described sounds very much like how the federal banking regulators operate. The Comptroller of the Currency for national banks, FDIC for state non-member banks, the Federal Reserve Board for state member banks, they both have supervision and they have enforcement, and it seems like in those cases, there is a proclivity to see if things can get resolved short of a formal enforcement action. Very often banks will enter into MOUs with their regulator. They're not even publicly announced, unless it's from a securities law standpoint, it's something material and needs to be disclosed. Doesn't that really align the CFPB with the way the federal banking regulators operate?

James Kim:

I agree, it does. Excellent observation. The model that you described isn't explicitly discussed in the internal memo that was circulated. But if you connect a variety of dots and you read the handwriting on the wall, I think a shift toward that paradigm or that model, the Prudential banking model, seems to be in the cards. But here's a big but though, with the Prudential regulators, OCC, FDIC, the Fed in particular, there is no distinction between supervised and non-supervised entities, all their members institutions are subject to supervision. So they get to examine all of their institutions and then turn to enforcement, if necessary.

James Kim:

The CFPB is a different animal because its enforcement authority is much broader than its supervisory authority to there is that gap, right. So if you use the Prudential banking model, that could work and would apply to supervised entities, both bank and non-bank, such as the large CRAs. But for all of the huge universe of non-banks that are subject to CFPB enforcement authority, and are subject to title 10 of Dodd-Frank, but aren't supervised, the only tool other than being subject to rules, right. But from an interactive perspective, there's no exams, the only tool is enforcement.

James Kim:

So I think whatever the plan is going forward has to address that. And of course they will, but my point is, your observation is a good one, I agree with it, but with that rather large caveat.

Alan Kaplinsky:

So what is the potential impact of this both short term and medium to long term? And let's put aside the results of the election and what that may might mean. Aside from that, how do you see this happening. Going to slow things down because there's going to be another extra layer of review, particularly at the beginning, once they roll it out and they're not used to how it's going to work. It might be even slower at the beginning. Might it reduced the number of investigations that get conducted of, let's say, non-supervised, non-bank? what do you think.

James Kim:

I agree that in the short term things probably will be slower because it's new and they need to work out the kinks. And every time they go through a decision making process with different scenarios, there's going to be some issues and bugs to work out. So I agree that, in the short term, it may slow things down. But in the medium to long term, I can see this change actually creating a more streamlined decision making process that might speed things up. In the past, you had conflict at times, between enforcement and supervision. And in other contexts such as the ARC committee decision, it was a group consensus decision. Those situations are all going to be superseded and replaced by consolidated decision making office, right. If for the time being or at least for the first person, it will be Peggy Twohig.

James Kim:

So, with that consolidation, there should be speed and efficiency because you don't have these disputes that might slow things down, you don't need consensus necessarily to make all of these tool choice decisions. It's going to be, the buck stops with one person.

Alan Kaplinsky:

Right. So I guess we haven't said it yet, but the so called ARC, and I'd like you to tell our listeners what ARC stands for, A-R-C, I guess. But once you do that and describe for our listeners what the role of ARC has been, does this mean ARC is out of the picture or will be?

James Kim:

I think unclear whether ARC will be abolished or not. The memo actually references ARC, suggesting that it's going to remain, although I think the ultimate authorities that reside with the new head of the SEFL Office of Policy. So ARC stands for action review committee. And it's not a very specific role when a supervised institution undergoes an exam, and at the end of the exam when they identify potential issues in violations, if they feel like they're at a point where they may be referred to enforcement, and there is a number of factors that feed into that decision. Then a part letter, in the banking world is a 15 day letter, is sent to the institution and the institution gets to respond.

James Kim:

And with the report from the Office of supervision about the exam and the issues they've found with their recommendation, as well as the company's response, the ARC committee will sit down and make a decision about what to do with that company on those set of issues. Keep it within supervision, transfer it to enforcement. Sometimes there's a split, some issues remain with supervision and they're dealt with through an MOU or MRAs, but then some issues, perhaps the more you'd have issues, the issues that you would think would go to enforcement, as opposed to the technical issues, will get transferred to enforcement. So that's what the ARC committee does.

Alan Kaplinsky:

Yes. And who's on that committee? Not the names of the actual people because I know that will change, but who would be on that?

James Kim:

So, it's a cross section of the SEFL leadership. So, it's the head of supervision, the head of enforcement, head of fair lending, and then there will be a few people from outside of SEFL, certainly the director, not the director personally, but someone from the director's staff. So front office is what I call it. Someone from the director's front office will sit in and have a voice. So that's the general makeup with the key personnel being the heads of the three SEFL offices plus a representative from the director's office. So, that's the makeup of ARC.

James Kim:

And as I mentioned, the memorandum that we're talking about, and that's in the reorg, suggest because it continues to mention ARC as continuing to exist committee, but as I said before, it was this jumbled consensus, and sometimes a debate or fight that could hold things up among ARC committee members. Now, I think it'll probably exist as a deliberative body to help discuss, and vet, and analyze these issues and the decisions but the ultimate authority unquestionably will be with the new head of SEFL policy.

Alan Kaplinsky:

Sure. So after an article I think got published in Bloomberg about this, Bloomberg Law, there was a response, right, from some people on the hill, I think, Congressman Sherrod, I hope I pronounced his first name correctly, Brown didn't like it. I don't know who else squawked about it, maybe some other consumer trade associations didn't like it. They viewed it as anti-consumer, I'm I right?

James Kim:

Yes. So Brown's office sent the letter, and there may have been some public remarks about it as well. But yes, I think the gist of it is, what is the timing? Why now so late in the game before the election? Don't force a change before potential change in administration. And also the the substance of the change, right. Concern that it's going to weaken oversight over the industry companies, especially those that are only subject to enforcement and not supervision.

Alan Kaplinsky:

Yes. And my guess is, just a guess, that Sherrod Brown does not know Peggy Twohig, who has been indicated, will head up this new area that will be involved in making decisions, whether to pursue investigation. Because if he had looked into her background, I think he would have been surprised to find out that she is about as bipartisan as Dr. Fauci is. She knows from no political parties.

Alan Kaplinsky:

Her background is that before coming over to the CFPB to get involved in supervision, she was with the Federal Trade Commission in their division of consumer protection. She handled enforcement work at the FTC. When Dodd-Frank was enacted, she was one of a small group of people who got recruited from various other agencies to go over to the Treasury Department to be involved in standing up the CFPB. Back after the enactment of Dodd-Frank in July 21, 2010, I think. So between that date, and July 21, 2011, she was at the Treasury, the Obama Treasury Department, okay, and that has nothing to do with Trump here.

Alan Kaplinsky:

And she was involved in standing it up and she worked for several years under I think Raj Date, who may have been an acting director for a period of time. And then when Richard Cordray got nominated but then there was the hiccup involved of course in his nomination. But the point is, through the duration, the whole life of the CFPB, I guess probably one of the most senior people who was there at the beginning, who knows more institutionally about the CFPB than anybody else, and is still there, and she's certainly not one of Trump's political people who got sent over to the Bureau. She is A political, I mean, she truly is Dr. Fauci to the CFPB.

Alan Kaplinsky:

I can't think of anybody in a better position to take on that role than Peggy Twohig. And I happen to know her personally. And I can vouch for that. And when you think about it institutionally, she's been involved as the head of supervision policy in all the decisions to dealing with supervised institutions, to decide whether or not they should be referred to enforcement or whether they should be dealt with on the supervision side, which generally means dealt with privately and confidentially.

Alan Kaplinsky:

So now, she's going to be involved in everything. It not only will be supervised institutions, but non-supervised institutions. She'll be involved in a decision between pursuing the matter through a supervisory channel or an enforcement channel, which should ensure more consistency with respect to making sure that companies and banks are treated the same for whatever the same problem or issue might be. So, that's my two cents that I wanted to add in. It really annoyed me to see a knee jerk reaction on the part of senator Brown or Congressman, I'm not even sure which. I know he's from Ohio. Do you know, James?

James Kim:

It's Senator Brown.

Alan Kaplinsky:

Senator Brown, yes. I called him a congressman. But what is your reaction to what I've said. I'm sure you met Peggy when you were at the Bureau, but am I right? Is she the Dr. Fauci?

James Kim:

I agree that her track record and her resume are unquestionably very strong and that she is indisputably well qualified for the job and by partisan as well. She's had a long career to government under various administrations. So, I don't think there's any basis to criticize the selection of Peggy Twohig to hold what will be this new position.

James Kim:

I don't understand exactly the, the underlying concern that Senator Brown and some of these other critics may have, but if I could take a stab at it and say something like this, if I'm playing devil's advocate, this is not about the qualifications of Peggy Twohig or any particular person that may hold that office, the criticism would be structural in nature, in that you're taking autonomy away from enforcement which had been to date and even currently under director Kraninger, a very robust office that had significant independence, and to be struck fear at times in the industry. And I think certain people would say those are good things. And that following the Prudential banking model is a mistake because the financial crisis of 2008 and 2009 proved that that model was ineffective, and ultimately soft, and didn't properly prioritize Consumer Protection.

James Kim:

So I think those criticism, those observations, are all a matter of public record. There are people who think that the Prudential regulators have a problem of regulatory capture, I would note that the FDIC recently has gone so far as to actually address the criticism and to say that they have an initiative to research and address as appropriate the risk of regulatory capture. So, like I said, to play devil's advocate, I think those would be some of the criticisms that would be divorced from any particular person and that person's qualifications.

Alan Kaplinsky:

Yes. I hear you, James. And, James, I guess the only thing we haven't really focused on, and I'd really don't want to dwell on it because I think it's almost very obvious that with the election coming up, if there is a change at the very top and Kathy Kraninger get ... meaning that we have a new president and Biden ends up replacing Kathy Kraninger, that new director is certainly is going to have a lot of influence into whether or not this new reorganization actually gets rolled out, right. I mean, the new director may have a completely different view of things. I'm I right?

James Kim:

For sure. I think all bets are off if there's a change in the White House and then a new director on a variety of fronts at the CFPB. We could spend hours talking about all the different ways the bureau could change under a different director appointed by a democratic president. So I agree with you there. If I could just take a very high level observation, this announcement is interesting in a lot of respects, but this point about that really stuck with me, which is, from the beginning, including in the statute itself and the people that formed the Bureau and Director Cordray, there was a very conscious decision to have an integrated SEFL function, right. To integrate and coordinate supervision, enforcement and fair lending. And I think to differentiate it from some other regulators, and I think they saw real benefits to it.

James Kim:

But the tension that was created was have that integrated SEFL function, but to also make sure that enforcement is robust, independent, and strong. So, I always felt there was some inherent tension there. And to a certain extent, the proposed changes are consistent with the initial concept of having an integrated SEFL function, if that's the case, then why not have a consolidated decision making out of channel within SEFL? So it's this weird thing where it's almost like the announced changes, which are dramatic, and somewhat controversial in the eyes of some, in many ways come full circle and are consistent with what I think, in many respects, was the initial vision for SEFL, which is to have it be an integrated function.

James Kim:

But again, I think we all recognize there's an inherent tension between having enforcement being independent and robust, but also having a coordinated effort between supervision and enforcement. So, I don't claim to have the answer, but it's just an observation that I had that people say it's such a dramatic change and I'm like, it is but it really isn't.

Alan Kaplinsky:

Right. The really dramatic thing, of course, is that the CFPB was created as an independent agency, and of a single director, and funding being provided by the Fed, not coming from congressional appropriations, that was the real dramatic event that occurred more than 10 years ago.

Alan Kaplinsky:

Anyway, we've come to the end of our program today. And James, I want to thank you very much for shedding some light on what has turned out to be a rather controversial and contentious topic. So thank you for being part of the discussion today. And I want to thank our listeners today and remind you that our podcast show, new one, gets released every Thursday, except for two weeks during the year, when Thursday falls on illegal holiday. And you can find our podcasts on our website or you can find them wherever you get your podcast shows, be it on Spotify, Google Play, whatever the platform is, we are there, Consumer Finance Monitor. So, again, I want to thank everyone very much for listening today.