Consumer Finance Monitor (Season 5, Episode 19): The CFPB Invokes its "Dormant Authority" to Supervise Nonbanks that Present Risks to Consumers: What it Means for Nonbank Providers of Consumer Financial Products and Services

Speakers: John Grugan, Michael Gordon, and Lisa Lanham

John Grugan:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, for your customers, and for the industry. I'm your host, John Grugan. I'm a partner in Ballard Spahr's Litigation Department and I'll be moderating today's program. For those of you who want even more information than we'll offer today, don't forget about our blog, consumerfinancemonitor.com. We've hosted the blog since 2011, so there is an awful lot of relevant industry information there. We also regularly host webinars on subjects of interest to those in the industry, so to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. If you like our podcast, please let us know, leave us a review on Apple Podcasts, on Google, or wherever you get your podcasts.

John Grugan:

Today, I'm joined by my partners, Mike Gordon and Lisa Lanham. Mike is an alumnus of the CFPB, where he was the senior counselor to Richard Cordray among other positions. And he focuses his practice on advising a wide range of clients on the CFPB's exercise of its supervisory and enforcement authorities. Mike also was a general counsel of a fintech company and has held other government positions and so his practice goes well beyond merely CFPB enforcement and supervision. Lisa Lanham's practice focuses on advising financial services companies on matters related to state licensure and federal approvals necessary to conduct business for a variety of asset classes. And she can be particularly helpful to fintech companies as they navigate licensure requirements.

John Grugan:

Today, we're going to be talking about the April 25th announcement by the CFPB, that it intends to invoke its dormant authority to examine non-bank companies that it claims pose risks to consumers. Mike, let's just get started with the basics. What exactly did the CFPB do and does it really have the authority to expand its supervisory authority?

Michael Gordon:

Well, it's an odd notion that a regulator could unilaterally decide to expand its authority, but in fact, Dodd-Frank gave the CFPB this tool. It might be helpful first to step back and clarify that we're talking about the Bureau's supervisory authority. This is the authority it has to examine the books and records of a company to interview company personnel and it's a wide ranging and in-depth examination of a company. They separately have enforcement authority and that tends to be more targeted towards particular conduct that the Bureau is concerned about and comes with it, different kinds of procedural safeguards that don't really exist in the supervisory context.

Michael Gordon:

So what we're talking about with this most recent bureau action is expanding the number and the types of companies that the Bureau can do these examinations of. And in Dodd-Frank, the Bureau was given essentially three different sources of authority for supervising entities, and it was divided initially by marketplace and industry. In the statute, the Bureau was given examination authority or supervisory authority over large banks, banks with $10 billion in assets or greater. And then, a number of non-banks that were deemed important at the time by Congress, such as mortgage companies, payday lenders, and private student lenders.

Michael Gordon:

So that was the supervisory jurisdiction that the Bureau had at its inception, but the statute allowed the Bureau to expand that in two ways. The first way is by passing a rule, saying, "We are going to tackle a whole new industry." And this is called the larger participant rule. And it allows the Bureau to identify an industry, set thresholds for which of the larger participants in that marketplace they're going to examine and it's subject to all the normal rulemaking procedures and notice and comment, etc. And they've invoked that authority on a number of occasions to expand their supervisory jurisdiction to consumer reporting companies, debt collection companies, student loan servicing companies, auto finance companies, and international money transfers.

Michael Gordon:

The last and final source of jurisdictional authority to supervise entities comes from a sort of a catchall that we're talking about today, that the Bureau hasn't really used yet. And so that's why it's news that the Bureau is invoking this, what we're calling a dormant authority. And this catchall basically says that the Bureau, in addition to these marketplaces that Congress identified and additional ones that the Bureau may have identified by rule making, also can supervise a non-bank that the Bureau has reasonable cause to determine is engaging in conduct that poses risks to consumers with regard to the offering of consumer financial services and products. And that's the authority that the Bureau is now announcing we're going to use.

Michael Gordon:

And what I just read to you was language from the statute about what this risk-based authority is and there's not much more. There's a process in the statute for how it makes that determination, but there's any clear guidance on what kind of risks or how to gauge the risk that would trigger this new authority. And the Bureau isn't proposing a rule making where it's going to tell us more about how it's going to make that decision, it's just saying that we're going to start using this risk-based authority and if we see a company that we think is posing risk to consumers, we're going to assert our supervisory authority over them and conduct an exam.

John Grugan:

So Mike, how though in practice is that going to work? Is it just the CFPB's subjective sense of risk? I mean, there has to be some standard that it can resort to in order to determine whether a company is posing risks to consumers and therefore should be supervised, right?

Michael Gordon:

Well, there currently isn't one in the statute, the Bureau's not proposing to delineate one. And unless and until this gets litigated, I don't think the Bureau will be forced to do one. I mean, the short answer here is the Bureau's going to know it when they see it, they're going to decide if they want to use this authority and they're going to do so based on their perception of risk to consumers. The only thing the statute says, and that the Bureau echoed in its announcement about this so-called risk determination, is that there's a little bit of a procedural hurdle, which is they give notice to the company and the company has certain amount of time to respond. And in addition, it talks about the basis for the reasonable cause of risk, but it simply says that this reasonable cause can be based on things like consumer complaints and any other information that the Bureau has. And the Bureau listed several other categories, such as whistleblower complaints, litigation, information from other regulators, even press reports.

Michael Gordon:

So it's really wide ranging, the information it could use to create this reasonable presumption or reasonable cause that there's requisite risk. And when I was at the Bureau, we passed a basic kind of procedural rule to talk about how this risk determination was going to be made, so it gives a company a chance to respond, but we never really invoked it to actually examine any particular company. It was not deemed necessary at that time, the Bureau had a lot of different industries to examine. And what I would note about the recent announcement by the Bureau that was perhaps the most surprising part of it, was not that you're just going to use this authority, but that they're going to make it public.

Michael Gordon:

And the reason that's a surprise is because supervisory activity is traditionally highly confidential. When a bank or a non-bank is being examined by the Bureau, the Bureau doesn't talk about it and the supervised entity's not allowed to talk about it either. There are confidentiality rules of the Bureau, but in its announcement recently, the Bureau said, "We're going to change the rule that we had initially put out there in the early years of the Bureau to give the director the ability to publish the risk determination that we make when we're exerting this new authority." And that could include even naming the company that they've reached out to examine.

Michael Gordon:

So think about that. I mean, where that leaves us is the Bureau can unilaterally decide which non-bank entity it thinks poses risk. It can do so based on any type of info, basically, including unsubstantiated consumer complaints or press reports. And then it can publicly describe this risky conduct and name the company, causing reputational harm perhaps before the exam has even started, much less any findings of a violation. So this public part of it, it was quite surprising and certainly has folks in the industry concerned. And I would add that the company that's targeted here, if they're named publicly, kind of has limited ability to defend itself because confidentiality rules still apply to the entities subject to supervision. So the Bureau's going to have an announcement about something risky you're doing, and you'll be very limited in what you can say in response, because you're not supposed to talk about supervisory activity.

John Grugan:

Well, I imagine that that will be part of any litigation that comes up, meaning that the companies due process rights, and other rights necessary to defend its own reputation, are being impaired, not to mention the fact that it shouldn't have been supervised in the first instance, but what does all this mean now for companies that are at risk of being examined by the CFPB?

Michael Gordon:

Well, first I put it into the broader context of regulation in D.C. and in the states, where this is just part of a larger trend towards greater regulatory scrutiny over fintechs and other non-bank providers. Also, for this current leadership at the CFPB, I see it as part of inconsistent with Director Chopra's push to use every conceivable tool in the Bureau's toolkit, and to give him the ability to move quickly in order to encourage industry-wide change. If you think about the rule change that the Bureau's proposing, which would allow it to make public its concerns about a company, a real value to the Bureau in doing that is to send a signal to an entire industry about a practice, so that others are on notice that the Bureau is concerned.

Michael Gordon:

And in an environment where Director Chopra has to assume his term ends at the end of this presidential term, he has a limited amount of time to accomplish a lot of goals. And he wants to use every tool he can to encourage changes in behavior that he wants to see in these markets. He'll do that through enforcement actions, but he also does it very much through the bully pulpit, in speeches, and other guidance documents. And this is just one more tool, I think, to do that. Obviously, the companies that are choosing for exams will have quite a burden individually, but the fact that they will make their risk determinations public will send a signal to the Bureau that hopefully from their perspective will lead to changes industry-wide.

Michael Gordon:

So this new authority could be utilized against any covered provider of consumer financial products or services that isn't already subject to supervision. So if you were a provider of those services now, you could be subject to enforcement, but not supervision. And we know there's been tremendous growth and innovation in a variety of fintech marketplaces in recent years. And I think about the types of products or industries that could be affected here, I think about potentially buy now, pay later, and other alternative credit products, all kinds of payments products and services, marketing, servicing, crypto, lead generation. I mean, the list goes on and on of actors in the consumer financial marketplace that aren't currently supervised.

Michael Gordon:

And the Bureau always will pick a few to make an example of, and to draw attention to practices that is concerned about. And so companies will have a very short notice period before which they're going to be subject to a CFPB exam. And these are those in-depth exams that I spoke about earlier. Some licensed financial services providers might have already experienced state law exams or by a state regulator, but without getting into the details, I will just say in short, it's been my experience that a CFPB exam can be quite different from a state regulator exam, and it can be more wide ranging and intrusive.

Lisa Lanham:

And just jumping in here from the state perspective, I would tend to agree with that. In my practice, I tend to see a lot of state examinations under your state licenses, and they just have a different tenor to them. Although I will say more often as of late, when it comes to these more unique products, there's this concept amongst the regulators that you can't innovate around regulations. So the exams, they kind of know what's going on. Within the non-bank financial institution space, we're seeing more targeted questions and tailored questions to really get at whether or not there's some of these arrangements in place and they're digging in. So it's been, especially when they smell somethings going on, like a non-bank financial institution with an alternative credit product, we've tended to notice that they're a little bit more biting and potentially even a little bit more adversarial in some of their responses and questions.

John Grugan:

So, Mike, what should a company do now to prepare for a CFPB exam in the event that it is selected, that it's determined to pose sufficient risk?

Michael Gordon:

Well, the first question I'd ask is, what can the company do to avoid being a CFPB target in the first place? And we advise companies all the time on this question, and it depends on a whole bunch of factors, including the nature of your business, the products and services you're providing, the CFPB's priorities at any given time, so that's sort of a general answer. A more specific answer sort of has to be tailored to the company and its own risk profile, but in general, I would say one thing to do that's always good kind of compliance hygiene and the Bureau is always focused on, is consumer complaints. These are often an early warning system for problems and companies can always review their complaints, so they know what concerns consumers have, can respond to those concerns and can make changes in the processes they have as needed.

Michael Gordon:

And I will say, one of the first things the Bureau will do when they do an exam is examine consumer complaints. So getting ahead of that is always a useful exercise, stay on top of those, monitor them, do the root cause analysis as necessary. But in general, preparedness for an exam is something you have to prepare well ahead for. Last-minute changes that you might make before the examiners walk on the door are not going to carry a lot of weight with the Bureau, so if you are subject to exam, you want to make sure you have the kind of compliance management system in place that the Bureau expects to see in regulated entities. And there's not a lot of mystery to the components of this, but it's a certain amount of work to put it in place and make sure it's tailored to your business. And it can be new to growing fintech companies that aren't used to these kinds of regulatory expectations.

Michael Gordon:

So a compliance management system in short is how a company learns about its compliance responsibilities, ensures that the requirements are being followed and takes corrective action when necessary. And each compliance management system will vary based on the company's activities, but the common components include things like obviously policies and procedures, training, monitoring, or audit function, a consumer complaint response, and some level of board and management oversight, which is something the Bureau from day one has made a priority. They want accountability for the compliance function at the top of the house. And I've helped a number of small and large companies ensure that they have appropriate compliance management systems in place and they're prepared for an exam.

Michael Gordon:

And of course, larger, more complex institutions are expected to have more robust compliance management systems than small entities. The key is risk management. And it's a risk-focused exercise based on the risk profile of your company, but there is an expectation the Bureau has about the way it's going to look and we have a lot of experience helping companies get prepared in that regard. And then, the last thing I would say that companies can do now is, aside from minding their own house, is pay close attention to what the Bureau's doing. Companies should monitor what the CFPB is doing and what they care about. This doesn't include only the formal risk determinations that may come out as a result of this rule change, but all their other actions and statements that indicate what practices they're really concerned about.

John Grugan:

Lisa, Mike mentioned a little bit ago that one of the risk factors that the Bureau might consider is state enforcement activity. And you alluded to this a little bit just a second ago, but have the states been focused on examining non-bank financial institutions?

Lisa Lanham:

They have been, and not always in the context of a traditional state exam. We're certainly seeing questions out of state exam materials for licensed entities that really dig into whether or not somebody has a bank partner and what control over the bank partner that non-bank entity has. We've been seeing that, but we've also been seeing things like soft inquiries into the industry. Earlier on this year, towards the end of last year, Maine released something that a couple of people that we know of received. It was just a bunch of questions about what their business activities are and it just so happened that all of those entities that we knew of tended to be marketplace lenders. And so people offering more of a unique product and they're trying to solve an issue that banks have had with applications being streamlined and on a convenient platform.

Lisa Lanham:

They're really digging into this stuff, but even on the legislative front, I mean, you can tell that there's a heightened scrutiny of these alternative credit products. There's just this sense amongst the states, and at the federal level too, but amongst the states, that a lot of these products, because they're unique and they fall outside of traditional concepts of what would be covered under a statute or a regulation, that they're predatory. And that there's something that we need to watch out for and maybe be extra aware of and really question. So there's definitely been a focus from the states on these types of alternative credit products and how it is that we might get them regulated.

John Grugan:

So what impact do you think this announcement may have on state efforts to further regulate non-banks?

Lisa Lanham:

So it's interesting. The states tend to always be looking towards the CFPB, it seems to me at least, as their lighthouse. And what's important to the CFPB is going to be important to them. So similar to what Mike was saying before, that companies for their compliance platforms really need to be looking at what the CFPB is saying and what leadership is talking about, I feel the same way, I tend to look at, and this is how Mike and I actually started talking about this topic at all together, is that I tend to look to see what the CFPB is interested in, because I think that you're going to see the states coming around after the CFPB with a similar focus. And there's a couple of states that I would really expect it out of. And it's those that enacted these sort of mini CFPBs to fill this perceived regulatory void.

Lisa Lanham:

During the Trump administration, people were really worried that the CFPB was going to have no teeth, so the states took it upon themselves to really stand up their own mini CFPBs. And I think right now it's California, New York, New Jersey, Maryland, Pennsylvania, and Virginia. But those are states that I would really expect to look towards the CFPB and say, "Well, if they're going to be focused on it, so are we." I very intentionally used the verbiage, you can't innovate around regulation. And that's something that a regulator said to me at one point years ago, when these products were starting to come out. They can't change the laws and the regulations as quickly as they can change how it is that they're able to interpret the existing laws and regulations. So I just think that we're going to see a bunch of states looking at what's on their books and through enforcement efforts or exam efforts, really try to figure out how it is that they're going to better regulate alternative credit products to be more in line with what the CFPB just came out with.

John Grugan:

All right. Well, Lisa, Mike, thank you so much. This has been really informative. Everyone, please make sure to visit our website, www.ballardspahr.com, where you can subscribe to the show in Apple Podcasts, Google, Spotify, or your favorite podcast platform. Don't forget to check out our blog, Consumer Finance Monitor for daily insights into the financial services industry. If you have any questions or suggestions for the show, please email podcast@ballardspahr.com, and we'd be delighted to take your suggestions and please stay tuned each Thursday for a new episode. Thank you so much for listening.