Consumer Finance Monitor (Season 5, Episode 26): Innovative Products: Understanding the Regulatory and Enforcement Risks

Speakers: Alan Kaplinsky, Michael Guerrero, Michael Gordon, Lisa Lanham, and Rinaldo Martinez

Alan Kaplinsky:

Welcome to Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for industry and for consumers. I'm Alan Kaplinsky, Senior Counsel at Ballard Spahr, and I'm the former Practice Group Leader of the consumer financial services group. This is going to be a repurposed webinar, a webinar that we did not too long ago. And we focused on innovative consumer finance products, which can take a wide variety of forms. But we're going to only have time to focus on a few of the more popular ones and in particular the Buy Now Pay Later product, which has really caught the retailing industry by storm. It has reached a point now where it has become highly competitive with the credit card product. Which of course has existed for many decades.

Alan Kaplinsky:

So what we're going to do is, we have four speakers, all of them from Ballard Spahr today, who I will introduce in a moment. But each of them will focus on different products and different issues and we will pretty much go around the horn, most of the focus initially will be on state law and in particular state regulatory requirements including licensing obligations and where we see state regulators focusing in their examinations and oversight. What are they going to be looking for? And then, we're also going to focus on the CFPB. It seems like we can hardly ever do a webinar or podcast without focusing on them because they are so active these days. So let me introduce for you now our presenters today. Mike Guerrero, who is a Partner in our Los Angeles office. Lisa Lanham, Partner in our Philadelphia office. Rinaldo Martinez, Of Counsel in our DC office. And last, Michael Gordon who is a Partner in our DC office. Michael has been on a few other webinars, and Michael at one time not too long ago in his career had a very senior position at the CFPB, where he actually was an aid to the then director of the CFPB Richard Cordray. So without further ado, I want to turn the program over to Mike.

Michael Guerrero:

So I'm going to spend some time just discussing and giving an overview on different product constructs that we're seeing. There are many, and we're not going to have time to cover them all. But some of the ones I've included here are the ones that we're seeing either clients wanting to enter the market or regulators scrutinizing these products. So we'll speak to Buy Now Pay Later, closed-end installment products used to finance personal property, what I'm calling Delay Pay, and we'll get into that. And the last one is card-based products. And this one, there's actually a few products we'll discuss. We're going to discuss open and closed-end card-based products.

Michael Guerrero:

So Buy Now Pay Later, this is a very popular product and it has recently and continues to attract scrutiny. It's an extension of credit that's repayable in four installments with 0% APR. The reason it's structured this way is so that the Truth in Lending Act does not apply, which would mean more streamlined user experience for the consumer. In my view, very friendly consumer product. The proceeds of this product are dispersed directly to the merchant. So the way it's typically structured, you'll have a lender that partners with the merchant, that lets the consumer buy the goods through the lender, and then the lender would disperse the proceeds directly to the merchant.

Michael Guerrero:

The first installment on these products is typically due at consummation when the goods are purchased, and then the remaining payments are due in two-week increments. So the term tends to be about six weeks. One thing to consider in relation to that six-week term is when the Payday Loan Rule becomes effective, and I know that's in flux right now, these types of products are likely to be subject to the rule. The Payday Loan Rule will have limitations on processing payments after delinquent or NSFs and notices that have to be sent to consumers before the first payment or unusual payments.

Michael Guerrero:

These products frequently do not have a fee associated with it, but it's not uncommon to see a late fee or some other form of a fee, a reactivation fee for example, which would preclude a consumer from getting a new Buy Now Pay Later product unless they reactivate their account had it previously gone delinquent. A key issue when it comes to fees, and fees do attract a lot of scrutiny, is the fee a finance charge? Because if it's a finance charge, the Truth in Lending Act will apply. Another issue relating to fees is what does the amount of the fee look like in relation to the total price of the obligation? A $5 fee might not sound like a lot, but if we're talking about a $30 or $40 extension of credit with potential for three to $5 fees, it starts to look like a lot.

Michael Guerrero:

Another key issue for these products is how is it structured? So it can be structured in one of two ways. It can be a loan or a credit sale or retail installment contract. And from the consumer's perspective, they're going to look the same. But they have drastic impacts on the legality of the program, or the legal considerations rather. So if it's a loan, you have a third-party lender that's going to enter into an agreement directly with the consumer and disperse the proceeds of that loan to the merchant. So essentially, the seller merchant is paying a fee to the third-party lender to make the loan. License lender laws may apply, and the lease is going to get into that shortly, not withstanding the 0% rate. And if interest is imposed, I know we're talking Buy Now Pay Later, but we'll talk about another product shortly, it is interest. There's another concept of time price differential. That's not this. This is interest.

Michael Guerrero:

So if you have a credit sale, like I said, it looks the same to a consumer, but you have an extension of credit technically from the merchant directly to the consumer. And then the merchant sells that paper to a third-party lender or sales finance company. Under a credit sale, the concept, which is recognized a common law in nearly every state, is that the merchant has the ability to sell their goods at whatever price they would choose. So they can have a cash price and they can have what's called a time price. And that time price, which is a higher price for the ability to pay for something over time, tends to have that finance charge component. The difference between the cash price and the time price you might hear being called the time price differential. Under the Truth in Lending act, that's a finance charge.

Michael Guerrero:

The revenue is generally realized in the form of a discount on the face value of the paper. So when the sales finance company purchases the paper, they're buying it for a discount from the face value. A common example of this would be a car dealer. Consumer goes into a dealer, the dealer enters into a retail installment contract for the purchase of a vehicle with the consumer, and then the dealer will go ahead and sell that obligation on the secondary to a sales finance company.

Michael Guerrero:

The reason that distinction is important is because the disclosures are different, the rate caps are different, the licensing requirements are different. It's very important to properly characterize the transaction. For example, at the end of 2019, early 2020, California entered into consent orders with a handful of industry participants who were calling their products retail installment contracts, were not getting licensed as a California finance lender. And that was largely because some of these

products did not follow some formalities that were required to really structure the program properly for a retail installment construct. We've seen other states be aggressive recently. Georgia might be one of them.

Michael Guerrero:

And finally, I'll just note a couple issues that we're seeing on the Buy Now Pay Later front. Just this week, for example, the Bureau gave guidance on credit reporting for Buy Now Pay Later products. They are encouraging consumer reporting agencies to create functionality to capture these obligations. This has historically been something that's difficult to report to the IRS. In association with that, the Bureau indicated that they do not like the concept of positive only credit reporting. They want both positive and negative reporting. They want an accurate snapshot of the consumer's payment history. And they also don't like the concept of having a separate Buy Now Pay Later score. I know that's been picking up some traction lately. The Bureau was fairly clear in their response to that.

Michael Guerrero:

The last thing I'll speak to on this before I kick it over to Lisa to discuss licensing considerations for this type of product, would be the Bureau last year sent out an inquiry to a lot of Buy Now Pay Later participants. And along inquiry, a lot of questions, but some of the things that jumped out to me are the Bureau really wants to know what's going on with disputes. So if you're in a credit card context, there's a very robust dispute framework. But when you're talking about a Buy Now Pay Later product, the guiding principle tends be the FTC holder rule. And even her with no finance charge, that might not apply. So the Bureau wants to know how are you handling disputes. They want to know what are the limitations on the frequency and amounts of these products that you're setting for your consumers.

Michael Guerrero:

Are you making sure consumers can repay? Do you have any protections against loan stacking? So that's where the consumer will go out and get loans from a bunch of different Buy Now Pay Later providers, and might not necessarily be able to repay those. They want to know what merchant categories consumers are in, or you are lending in. Some, in my view, present more risk than others. And they ask specifically about these home improvement contracting, elective medical procedures. A couple other questions that jumped out, they want to know about your payment reminder practices and metrics associated with that. So do you have some consumers that are getting payment reminders and some that aren't? What's the delinquency rate for each of those? Are you utilizing virtual cards? We'll speak to that in a little bit. And then what's your checkout experience? I think they're looking for UDAP considerations here. Does the consumer understand the terms? What does that look like? But with that, let me turn it over to Lisa, because 0% APR, four or fewer installments does not mean you get a free pass on licensing. So Lisa, I'll turn it to you.

Lisa Lanham:

Thanks, Mike. Yeah. So the applicable licensing regime tends to turn on how your product is structured just like Mike said. If it's structured as a loan, then license lender or consumer lender licensing laws tend to apply. And the licensing requirement in many states does hinge on whether or not an interest or a finance charge is paid as a part of receiving credit. Many states do not require licensing when there's no interest or finance charge. But we're aware of about 10 to 15 states that will require a provider like this to be licensed, even if there is no interest or finance charge. When considering licensing requirements to offer BNPL products as loans, you may also need to consider whether or not payday lender licensing requirements apply because of the term. States generally require payday lender licenses to make short term loans. There're often triggered by offering these types of products at short term loans at very high interest rates.

Lisa Lanham:

However, some states require a license irrespective of whether any interest is charged. If structured as a retail installment contract, sales finance company licensing laws tend to apply. And these are separate licenses that are specifically geared towards regulating entities, entering into retail installment contracts to finance goods or services with consumers. As with the license lender or consumer lender licensing requirements, sales finance company licensing requirements may hinge on whether

a time price differential is included in the transaction. If it is not, then less licenses are likely to apply, but a number of them would apply irrespective of whether or not that's included. I'll kick it over to your Rinaldo because I know you have some thoughts on this product as well.

Rinaldo Martinez:

I'll start with this which I think is an important place to start, that we're talking about licensing, but even if a product is not subject to licensing, it may still be subject to other portions of a licensing statute. And I think that's something that we're seeing more of our clients becoming aware that even though a license is not required, you really need to look at the totality of the statute in order to see whether or not you have some requirements that apply to a particular product and so on and so forth. On the payday lending sector in particular that Lisa had mentioned, I think it's important to talk about the legislation that has been appearing in states like Illinois and other states, even California, limiting the interest rate on certain products with certain loan amounts to 36% is what we're usually seeing.

Rinaldo Martinez:

And in that regard cutting the legs off of payday lending as we used to know it, to a form that I think regulators are seeing are is a little bit less predatory for consumers. And the reason why that's important is because it's integral to peer to peer lending, when a FinTech company finds itself in the middle trying to comply with these laws that are coming through the pipeline for limiting interest rates. And Lisa, I don't know if you want to pick it back up with the other types of products or Mike, credit based products.

Michael Guerrero:

Yeah, I can jump back. So we talked about Buy Now Pay Later. The other kind of variant on this would be a longer term installment product. So it looks a lot like Buy Now Pay Later, but the difference is here, we have a interest charge or a time price differential finance charge. And we have a term that exceeds the four payments. Typically, you'll see six to 36 months. As Lisa and Rinaldo were speaking to the issue, licensed lender laws are much more likely to apply once you start having a finance charge imposed on the transaction. What we do see much more frequently here is a bank partnership. So a lender will partner with a bank to be the marketing administrator of the loan program. In these instances, the bank can avail itself to preemption for its rate authority. And it also gets quite a few exemptions from state licensing laws.

Michael Guerrero:

I'll let Lisa speak to that in a second, but I would note that these partnerships must be structured properly. They continue to attract a lot of scrutiny. The California Department of Financial Protection and Innovation, for example, aggressively tries to address or attack these partnerships. So for example, when AB 539, which is the rate cap under the CFL and AB 1864, which is the mini CFPB law were passed, Monique Limone was the sponsor. And in the commentary to these laws, bank partnerships were continually addressed. The state views these partnerships is potentially seeking to evade rate caps or licensing requirements.

Michael Guerrero:

Monique Limone with a few other state lawmakers just last month sent the letter to the FDIC, asking the FDIC to closely scrutinize these types of partnerships. A senior official at the CFPV at a consumer Federation of America event made comments that indicated that the agency is looking at and the way they defined this product contract was a rent a bank scheme. So these programs are attracting scrutiny and it's very important to structure them properly. I know Rinaldo's going to speak some other efforts on that shortly, but before that I'll turn it over to Lisa because even though these look very, very similar to Buy Now Pay Later, a host of additional licensing considerations could be triggered particularly on the bank partnership side.

Lisa Lanham:

Thanks Mike. Yeah. Similar to BNPL, the applicable licensing regime, again, turns on how the product is structured. If it's structured as a loan, then licensed lender or consumer lender licensing laws tend to apply. But because these products tend to carry interest in finance charges, more than 10 to 15 licenses are going to be required. Each state has its own licensing regime for these types of consumer products. So entities offering longer term installment products as loans tend to need licenses across the United States unless another exemption could apply. And each state has its own flavor of exemption statute, but things that could exempt what your organizational structure is. If you are a subsidiary of a bank or a credit union, you could find yourself being exempt. Again, as with the BNPL, if structured as a retail installment contract, sales financing company licensing laws tend to apply.

Lisa Lanham:

And because there are time price differentials included in these transactions, many more sales finance company licenses will also be apply. And it is, again, we'll need to find another exemption that could apply in order to fall outside of the state's licensing requirements. Specifically addressing the bank partnership licensing considerations, Mike and I are in total agreement that you need to structure them very carefully. And there's different licensing requirements that go along with the different activities that you plan to engage in. When you are helping consumers apply for loans from your bank partner, you could be considered a broker. When your bank partner originates loans and then assigns them to a separate entity in the bank partnership structure, taking assignment of those loans could also trigger state licensing requirements.

Lisa Lanham:

When you collect or service those types of loans, you're going to need collection or agency or servicing licenses. And each different business line has its own set of licenses. It's typically what we've seen is a couple of different entities that are involved. And really all those activities and how it is that you're engaging in the partnership, it could trigger those state licenses. And although I know you've done a ton of work on these with me, so please weigh in with your thoughts as well.

Rinaldo Martinez:

Yeah, for sure. And especially, again, I stress with this bank partnership model that we've been talking about, where you have a peer to peer technology platform facilitating credit to consumers, it is imperative to run down an analysis about what are you doing and who's doing what. If you have a bank partner or an exempt entity or some other lending partner doing the actual loans, what is your role in that? Are you actually lead generating for that person? And if so, are the lead generation statutes that apply to you? We've seen at least one state go after a company because they didn't get licensed as a registered as credit service organization, which are also as a host of other registration requirements that could apply to someone like a FinTech company that has a peer to platform.

Rinaldo Martinez:

All the way down to the securitization of these loans, once they're originated and if you are the person that takes assignment as a middle man, so to speak, and your intention is to securitize these loans, like who is holding the servicing rights at the end of the day? Do they stay with the originator? Do they get transferred to the assignee? And then you went into licensing considerations all the way down to the chain when you're doing securitization. And I'll talk about that a little bit later and I'll take it back to Lisa or to Mike.

Michael Guerrero:

Yeah. Thanks Rinaldo. Another product we're seeing not as popular as Buy Now Pay Later or an installment loan, but sometimes offered in conjunction with them as an ancillary offering as part of a suite of credit products or could be standalone, is Delay Pay, or what I'm calling Delay Pay. So this again could be a retail installment contract or loan, but typically it's a loan. And what we see is a product that gives the consumers 30 days to pay for a purchase. The thought is you get to try before you buy. So the 30 days generally corresponds with the merchants return policy. The consumer could buy the item,

make sure they like it, avail themselves to return policy if they do not and not have to pay for the product. It sounds straightforward and simple. No finance charge typically, potentially late fee. And I'm going to turn it over to Lisa. A big consideration for these types of products, especially if you're taking a payment authorization at the outset, is this a deferred presentment or payday loan or subject to those bonds? So Lisa, I'll kick it to you.

Lisa Lanham:

Yeah. So starting at the beginning, when considering these licensing requirements for Delay Pay products, entities still need to consider whether consumer lender or license lender, payday lender licenses apply. And like Mike mentioned, depending on how the product is structured, entities may also need to consider whether check casher or a deferred deposit licensing requirements also apply. If the consumer authorizes the provider to debit his or her bank account at a later date or if the consumer presents a check for the provider to hold, that's when you tend to see deferred deposit or check cash or licenses at play. At a high level, like I said, the licenses tend to apply whenever consumer presents a check or gives authorization to debit a bank account in exchange for money, and the promise to refrain from cashing the check or debiting the bank account until a later date. These licensing requirements tend to hinge on whether the activities themselves fall within the scope of the deferred deposit or check cash or licensing requirement.

Lisa Lanham:

And not whether, as we were mentioning before, interest or finance charges or a time price differentials are paid. We've worked with clients before offering this type of a product, and several regulators including Rhode Island, confirmed that their deferred deposit or check cash or licenses could apply. Something noteworthy I always tend to bring up, some of these license applications when you submit them, they require entities to maintain physical office locations with certain security and safety measures in place. Going back to Rhode Island, for example, they require a physical location that has bulletproof glass, alarms, vaults, camera surveillance, and a whole host of other things. The regulators there confirmed that there's really no flexibility around this requirement and it won't be waived even if the entity only does business online. So I always note that because it's something that may be prohibitive when deciding to go into business in Rhode Island.

Lisa Lanham:

Lastly, depending on the flow of funds, entities may also want to perform a review of whether state money transmitter licenses could apply. Again, at very high level, if the flow of funds requires the entity to transmit money or something of monetary value from one person to another, you should be reviewing your money transmitter licensing requirements and seeing if it is something that would apply to you. In short, entities engaging in this particular business line may need to consider three separate licensing regimes for applicability to their business. And unfortunately, we can take advantage of cross exemptions in a lot of different areas. If you hold one license, you may be exempt from another. That's generally what a cross exemption is. But unfortunately, there's not much to offer here in terms of cross exemptions because the licenses are just so they cover such different activity. Entities could actually be required in a lot of instances to obtain and maintain three distinct sets of licenses for the one business activity. So Michael, I'll send that back to you.

Michael Guerrero:

All right. Yeah. Thanks Lisa. The last product that we're going to speak to from this overview perspective would be card based products. And it's not just one product. And I think this is where most of the innovation is happening right now. The benefit from a lender's perspective to having a card based product is you don't need a relationship with every single merchant that is part of your program. Instead, you're relying on existing card networks to disperse the proceeds. So you can jump on to the Visa, MasterCard networks and utilize that to establish your merchant relationship. So you're dispersing the proceeds directly to a merchant through this mechanism.

Michael Guerrero:

The most common card based product is a credit card. There's a very good framework for offering that and you have Reg Z's open-end provisions a card act. I wouldn't necessarily call that an innovative product, but there are closed end products that

utilize a card that have implications under Reg Z. So the first question is, we may be using a card, a virtual card, but does a credit card for Reg Z purpose exist? And a credit card is a card plate device that could be used from time to time. So a product that becomes pretty popular is a one time use virtual card, a card that is issued to the consumer that can only be used one time. The consumer gets an extension of credit for a thousand dollars and they choose to buy an $800 item, that card can only be used for that one $800 purchase.

Michael Guerrero:

You have a one time use virtual card. It's not usable from time to time. It shouldn't be deemed a credit card for Reg Z purposes. If the card can be used from time to time, and we're still talking generally about closed end extensional credit here, an example of this before jumping in would be you give the consumer an open to buy of a thousand dollars. Like I said, they make that $800 purchase, and then they go back and buy something else with remaining $200. That card has now been used from time to time. So you're looking at a credit card, notwithstanding the fact that the underlying credit obligation is still going to be closed end. It's not replenishing, the consumer can't make payments and then regain access to that line. There are two frameworks that are contemplated here, and this falls under the definition of creditor and Reg Z.

Michael Guerrero:

The Buy Now Pay Later framework, so you have a 0% product for fewer installments with no written agreement. That looks like a charge card. So what happens is, you're subject to Reg Z's open-end provisions, but not necessarily the card act provisions. You have periodic statements, you have billing error resolution requirements. There's merchant related dispute substantive requirements. All sub part B of Reg Z is going to apply to the transaction. Now if a finance charge is imposed and it's pay or it's payable in more than four installments in an agreement, this product is probably one of the most complicated products you can offer. Because you're subject to both Reg Z's open end provisions, including most of the cardiac provisions or certain exempted ones like the Schumer disclosures and Reg Z's closed end provisions.

Michael Guerrero:

So you've opened yourself up to a very significant compliance obligation, by having a closed end extension of credit that's accessible through a credit card, when that extension of credit has a finance charge associated with it. So card based products, a lot of benefit from a marketplace consideration. You don't need that merchant relationship, but it's very, very important to think about how you're structuring that product so that you can properly identify the Reg Z compliance considerations. With that, I think I was going to turn it over to Ronaldo.

Rinaldo Martinez:

I'm going to bring it back to the bank partnership model because I think it's just relevant. And I'll start by pointing out what's obvious to everybody. I think there's an appetite for innovative products out there in the FinTech world. It's being met by with skepticism by a lot of state regulators. And two actions in particular that I think mentioning, which also appear in our consumer finance monitor, I encourage you to read them summaries of them there. One is a case in California brought by Opportunity Financial, OppFi, in which they're contesting. They're licensed as a CFL lender in California, but they're contesting the 36% rate cap imposed by the legislation that I had mentioned earlier, on the basis of the fact that they're partnered with a bank that is exempt from these limitations. And California's coming back and saying, no, you're actually subject to them because you were the true lender.

Rinaldo Martinez:

The other actions in Connecticut that I think was also mentioned earlier, and it's again solo funds. And this is not a case, it's an order brought by the Connecticut Department of Banking, again, solo funds. Under similar circumstances, solo funds partners with lenders that end up actually originating these loans and dispersing the funds to the consumer. But in Connecticut's case, they focused a little bit more on the totality of the transaction and who controls the transaction. What I find really interesting in both of these cases is that regulators approach them from a similar place. And as much as they're going after the peer to

peer technology that allows the consumer to get to the loan that's being made to them ultimately, but they did it from different angles.

Rinaldo Martinez:

California decided to focus on the predominant economic interest of the transaction, which is, well, we're hearing a lot with legislation coming through limiting interest rates. It's like, who has a predominant economic interest in the transaction? And of course, I think that's still being developed and I think it's very broad. So I think that FinTech companies, especially those that offer these peer to peer technology platforms to facilitate loans to consumers need to really consider these laws and their applicability. The order with Connecticut I think rests it a little bit more on a strict reading of the statute. There the issue with Connecticut was that Connecticut's claiming that solo loans funds is not properly licensed under their Small Loan Act. And that language of the Small Loan Act is actually quite broad. It covers offer, solicited broker, directly or indirectly arranged place find and includes assistance to a prospective Connecticut borrower in obtaining a small loan. And they were involved as a peer-to-peer technology platform.

Rinaldo Martinez:

They were involved in as much as they provided the platform where the borrower could apply to make the loan, even though it was ultimately their third party lenders making the loan. They provided the form for the promissory note and for the TILA disclosures. And I know that what we find a lot is that are these FinTechs and maybe part of our audiences members, they're really trying to do a lot for the consumer on behalf of the lending partners. But we really have to start considering that sense to which these laws might apply based on the activities that you are undertaking on behalf of the third party. And obviously, as we know, generally speaking, the bank partners who tend to be national, are state chartered banks, credit unions are largely exempt from licensing. But that doesn't mean that just because your bank partners exempt from licensing, it doesn't mean that you as the peer to peer technology, provider of services, connecting the consumer, are not subject to licensing, especially if you fit within the embed of these laws.

Rinaldo Martinez:

I also like to point out California, not to pick on California, but California's definition of broker under the California financing law is quite broad and it may cover activities that are not normally seen as brokering. I think we need to look at statutes that are broad like California's with a bit of circumspection as we move forward into this unknown territory of regulation. And look, I think we're looking at how to fit a square peg into a round hole here. These providers of services, these peer to peer platforms, they sometimes don't fit neatly into these laws. And regulators under the traditional regulatory schemes that are in place, are really trying to be creative, to regulate the industry.

Rinaldo Martinez:

And it'll be interesting to see how much further they're able to regulate. But for the actions that I just mentioned, again, I think what the takeaway from those is, the states that are going to focus on the predominant economic interest and what that's going to look like versus the states who are just going to look at the plain language of the statute and be like, hey, look, you were doing these things, whether you think you were doing them or not. Something else that was mentioned earlier that I think merits a lot of attention is the distinction between loans, retail installment contracts and credit sales. And loans versus RICs in particular, we've seen as drawing attention because some folks out there might think that they have a RIC in their hands and they're tailoring as a RIC, but some regulators are seeing it as loans and that can be very problematic for the product.

Rinaldo Martinez:

So we've seen cease and desist orders coming through the pike from states like Georgia. Georgia recently revamped their installment loan act a couple years ago to make the statute a little bit more broad in the way they define loan. And sometimes the regulator might look at the structure of your program a little bit differently than you're looking at it. So I think it's something to bear in mind as we move forward as well, the importance of using the right terminology when developing your

product and with advertising your product out there. And Lisa, please feel free to jump in if you'd like. I know that you have a lot to say also about the structuring of the products. So if you feel to interrupt me at any time.

Rinaldo Martinez:

The last thing that I think is worth mentioning before we kick this over to Mike Gordon is on the secondary market, how this implicates the secondary market as well. And I think I mentioned this earlier in the context of the securitization, when we're selling these assets, they're being originated, funded by the bank partner or the exempt partner. Usually they're assigned. Who are they being assigned to and who retains the servicing right? And to the extent that they're being assigned in connection with the securitization, are you really licensing everyone on the chain of the securitization? And up Texas is a prime example of this, where loans succumb within the purview of chapter 342, which is related to Loan Act in Texas, which relates to generally speaking to loans with interest above 10%. You have to be licensed. Every SPV in the chain of securitization and the trust entity, the issuer, needs to be licensed.

Rinaldo Martinez:

So, at the end, whether or not you're taking assignment of the servicing rights, as long as the loans are being transferred, the agreement from microsecond or just on paper, every entity meets to be licensed. But on top of that, who's retaining the servicing right? Do you have servicing considerations? Is it the originator that's keeping the servicing right? Is it the mass is the immediate assignee, the master purchaser? Or are you leaving the servicing of the loan with the originator? All these are licensing considerations that I think that need to be contemplated, especially for startups, FinTech startups, that are contemplating securitization later on. They should know that it doesn't just stop at your level or at the bank level, or even at the immediate assignee level. There's licensing considerations that are implicated down the chain as well.

Lisa Lanham:

Yeah. Just to jump in there real quickly too, there are some states that will allow you to enter into securitizations and seek permission to engage in this type of business without a license. So there's definitely some mechanisms out there where you don't need to be licensed, but it's a state by state consideration. It often requires the disclosure of a lot of your program documents. Regulators, Illinois in particular, tends to be very sophisticated and understanding what a securitization is and how each of the players operate. So it is something that's available just to note, but it's another situation where you may not need to be licensed, but other portions of the law might apply to you as Rinaldo had noted earlier.

Rinaldo Martinez:

No, and that's a good point Lisa. I think as scary as a landscape might be at this point for some, we also make clear that, yes, sometimes there are avenues to be exempt from licensing, sometimes there aren't. And not every state is the same. A lot of regulators are more tough than others and I think we've mentioned here some on the call. But I will end by saying that unfair deceptive acts and practices is another consideration that you need to have, because if you are caught red handed doing business without a license, a determination is made to that effect. You might also be violating a state's unfair deceptive acts and practices statute, which could carry not only reputational damage, but also civil penalties.

Rinaldo Martinez:

So yeah, I think it's a minefield in a little bit of it. But I think that hopefully the more products we see, the more innovation we see, the more regulators will start to understand that the landscape is always changing and that perhaps these traditional ways of regulating products really need to either catch up or new regulation needs to be in place. With that, I think I'll kick it to Mike Gordon who's going to talk to us on the federal side of things. More of a federal flavor, if you will.

Michael Gordon:

Thank you, Rinaldo. And just listening to you guys talk about that, it just echoes so many themes of what I've observed from the federal level, which is regulators hate a vacuum and when marketplace changes occur, they want to respond whether or not

there are logical extensions of existing authorities. So this square peg, round hole is something we see a lot. We certainly see it at the agency I know best, which is a CFPB, where they're going to find a way to reach conduct and legislatures may not have caught up for politics or other reasons, but regulators are under pressure to extend their existing authorities to reach new use cases all the time. And so that's just a truism and we see it over and over again. I want to briefly address some of the very many developments that have been happening in the federal space that are affected by this discussion.

Michael Gordon:

And the first thing I wanted to address was just generally, how do we look at the federal priorities right now, and how does that dovetail with this agenda? So, one thing that is becoming the new normal in financial services regulation at the federal level is more of a politicization than we've ever seen before. There are lots of reasons for that, and I don't want to get into them all because we don't have time. But the CFPB arguably has been that from the beginning. Other agencies are starting to creep more towards that model. And it's a sad development from my perspective. The independence of the bank regulatory scheme has always been one of its strengths in my view. And now, not just the CFPB but other bank agencies, we're going to be seeing policy shifts back and forth, kind of a quickly swinging pendulum.

Michael Gordon:

All the more so at the CFPB, which since the Supreme Court decision a couple years ago has a director that serves at the pleasure of the President, and therefore is closer to the White House than the independent director of a five year term that was envisioned when the statute was passed. So the practical effect of that is the White House agenda matters more and there's more probably coordination between a White House and what CFPB is doing. It priorities across the Biden administration right now. There's nothing bigger than the whole racial equity, racial reckoning agenda, which every agency in government is expected to deliver some progress on. And in this sphere, it's largely a fair lending question as well as other kind of special populations that since the Bureau's inception, have been singled out as important service members, students, the elderly, and in addition to all the federally protected classes in anti-fair lending and anti-discrimination laws. Another theme we see across the agencies is real concerns about the pace of innovation and in our sphere, in the FinTech area.

Michael Gordon:

And this is one when I was at the Bureau in the early years, I would describe the attitude towards innovation as more ambivalent. There was a recognition of some of the good things that were happening, and I hope that these innovations would lead to more access for people who didn't have access to financial products and services in the past, while concerns about consumer harm. Today, it seems much more tilted towards the skepticism of innovation. And we see that in a lot of the initiatives and the rhetoric that's coming out of the CFPB, but it's also with the other bank agencies as well. An example is the increased focus, and this has been a specific Bureau priority, on AI and machine learning, algorithms and how these things can have an impact on different demographics.

Michael Gordon:

There's a real concern that there's going to be unforeseen negative consequences and that these so-called black box approaches to underwriting and other decision making have a life of their own and have all kinds of impacts that may not even be intended or understood by those using them. And it's a very skeptical view of this stuff, which on the other hand, I think actually has a lot of promise for improving efficiency in decision making and accuracy and also expanding access. But there are certainly a balance to be made there. And at the moment, we just hear a lot from DC and from the CFPB about concerns from a fair lending perspective. There's a new theme that has really emerged from the Bureau that incorporates a lot of the old stuff they used to do, but adds a new dimension, and I would call it anti-competitive concerns. Rohit Chopra, the current director was most previously a commissioner of the FTC and had antitrust authority there.

Michael Gordon:

The Bureau, of course, doesn't specifically have antitrust authority, but he's injected this notion of competitive markets into a lot of the actions the Bureau has taken. And I think to the Bureau, this anti-competitiveness theme has several different

meanings that are distinct from one another. There's the traditional anti force like market concentration concern that what can the Bureau do about that? That's not really their role. And yet you hear Rohit Chopra talk about the big tech companies, payments platforms and other marketplaces where he's really concerned about the market power of bigger players and how they're using that market power. But the other way I think about this is really a different way to characterize problems that the Bureau has always been focused on, which is competitiveness in the sense of diluted competitive pressures. Marketplaces, where for one reason or another consumers can't vote with their feet, or there's something about the way products are structured, that makes it difficult to make what the Bureau would call a well informed, upfront decision about what you're getting into, so you can really compare competitors.

Michael Gordon:

So marketplaces that you can't choose your servicer or debt collector, credit reporting agency, your data aggregator, these are areas will see more those themes emerge and we'll see enforcement that leans on this stuff. We've already seen one case where you literally had captive consumers with the JPay case, was a case of folks who were incarcerated and were given their funds they had access to on certain payment mechanism when they left incarceration. And it was an abusiveness claim that was brought there that the payment provider was taking on reasonable advantage of that situation. That's a pretty extreme situation of captive consumers, but the point remains that you hear a lot about this at the Bureau, and it infuses a lot of the things that they care about.

Michael Gordon:

And then finally, a couple points about enforcement. Everyone understands the enforcement posture is more aggressive in this administration than the last. Well, some of the things we've seen is first of all, increased hiring. There's just more people, more resources devoted to that. I think more of a willingness within the Bureau to pick that tool over other tools. We're not going to see as much rule writing, which takes a lot of resources and a lot of time, but we'll see more enforcement, which can be accomplished in a shorter amount of time with fewer resources. And also in the struggles that exist within an agency like the Bureau between enforcement and supervision, sometimes they have different views on the same issue. Enforcement's going to win those now much more, not saying that they lost many in the past, but it was more of a fair fight in recent years than it is now.

Michael Gordon:

I think if Enforcement Attorney is interested in an issue and wants to run with it, there's much more freedom to do that, notwithstanding what other parts of the Bureau may think. Some of the other enforcement themes that keep coming up in speeches and actions are a focus on bigger players in marketplaces, a focus on repeat offenders and willingness to use more larger fines and other kind of remedies than we would've seen in recent years. And I think we're going to see a testing of the boundaries of the jurisdiction probably for the reason I mentioned before, which is the Bureau doesn't like a vacuum. BMPL takes off. They're going to find a way to reign it in whether or not it fits within the definition of a credit product. If there's a practice they don't like, they'll find a way to attack it.

Michael Gordon:

And I think they're willing and they've showed a willingness in some of the announcements they've made to test the boundaries of the agency's jurisdiction. And the point I would make about that is that, agencies only know where the boundaries are when they test them and lose in court really. And the Bureau may very well be willing to lose a few, have tolerance for that in order to gain some ground on the fringes. I want to spend just a minute on this. I want to highlight this because this announcement, that discrimination can constitute a UDAP, was a very large development that has potentially really far reaching implications for all kinds of providers. So the announcement that they made was that discrimination can be unfair. Remember unfairness is substantial injury, not reasonably avoidable and not outweighed by countervailing benefits.

Michael Gordon:

In this context, it really comes down to a substantial injury. Because the Bureau in its announcement said, how is discrimination avoidable? Consumer can't really reasonably avoid it. And the final problem of unfairness being outweighed by benefits is hardly everyone that really has any teeth to it. And so suddenly you've got discrimination and anti-discrimination concepts applied to a whole bunch of new products and markets with a totally different and streamlined legal theory underlying it, compared to the traditional jurisprudence and balancing tests and shifting of burdens that we're used to in anti-discrimination law that have been on the books for a long time. So a couple observations about this and then a couple quick points that are practical. This is one where it's really a novel interpretation. Will it be challenged in court? Yeah, at some point, I would note that the Bureau chose to make this announcement in a way that makes it difficult and maybe longer for it to be challenged in that way, because they did it through an exam manual revision and not a rule.

Michael Gordon:

And I think courts might be quite skeptical of this legal interpretation. If the Bureau's right, that UDAP can mean all things discrimination, then why would Congress have written all these anti-discrimination laws since UDAP existed? And why wouldn't they have been explicit in that statute and the UDAP statute that it covers that? I think there's some real fundamental questions about the theory. But in a practical sense, what it means is it covers a lot of entities that wouldn't have been covered by anti-discrimination restrictions, and it covers a lot of products and different aspects of products. So it pushes anti-discrimination law beyond just credit products, for example, and it creates a new way, a new lens you have to apply if you're a provider in this space, particularly if you're a non-bank that maybe has never been supervised or regulated on those grounds before.

Michael Gordon:

And it's difficult. It's made more challenging by the fact that, as I mentioned, the legal theory itself is new and quite uncertain as to what its boundaries are. But in terms of practical things to think about, companies should be reviewing not just lending activity, but all aspects of the life cycle of a loan product and as well as other products. So think about marketing activity, digital advertising, servicing, collections, payments, remittances, deposit accounts, all of these things fall within this new theory of discrimination as unfair, and depending on what the provider was, may have had no such restrictions in the past at least legally. Companies may need to think about how they're going to test for this. And you would want to be doing that under supervision of council, but there may be all kinds of new testing that would be appropriate.

Michael Gordon:

There may be revisions to policies and procedures that may seem unnecessary because, of course, you wouldn't think anyone at a bank is going to discriminate an account opening based on race. But if your policy doesn't say it now, you might want to just make that explicit or other aspects there. Your policies and procedures could be revised in light of this new approach that the Bureau's announced. Time to kick the tires a bit with this in mind, on decision making processes, your training materials, monitoring, even transaction testing may be appropriate in certain circumstances. And an important thing is, whereas you might not had to document it or think about it this way before, the business justification for certain practices now becomes really important because I think any company that's challenged under this UDAP theory is going to want to invoke some of the traditional anti-discrimination law.

Michael Gordon:

And having a sound business justification for a practice can be a really important factor in that analysis. And finally, if you find some problem, remediate it quickly. That's always good advice, but I think that might be particularly true here. Let's talk briefly about the expansion of non-bank oversight. Again, we did a podcast on this as well. The points I'd like to make here are just that the Bureau has taken it upon itself to use a tool that really hadn't been used before. It's another example of an aggressive TFB using every tool in the toolkit. But the effect of this is going to be that it can pick a company that it believes poses a risk to consumers. And not only conduct an exam of that company without any other preliminary rule making, but then make public the fact that it thinks this company or practice is risky and even name names as to the company they're examining.

Michael Gordon:

So in actual practice, I don't think the Bureau will be able to do a lot of these. Their supervision resources are stretched pretty thin. But they're going to pick a few and it'll be another way for them to send signals to the industry about practices they're concerned about. In terms of avoiding being a target for this, it's a lot of the things we would normally talk about. Non-bank and FinTechs that don't have sophisticated compliance management systems and aren't used to being subject to supervision, it may be a good time for them to review what they've got in place and build up a more robust compliance management system, the kind that the Bureau would expect to see if they came knocking. Moving on, the BNPL is an issue that Mike Guerrero covered at length. The Bureau has announced their interest in that through an inquiry to a number of companies.

Michael Gordon:

And I don't think we need to dwell on that in lot of the coverage of this issue we've already had today. And then finally, just a grab bag of a few other issues that I think are notable. The inquiry that the Bureau made to the large tech companies was an announcement that the Bureau wants to be a player as a regulator of those companies. And it's not surprising given Rohit Chopra's interest in those issues of the FTC that would continue, the Bureau certainly has a role in regulating payment platforms. And yet, if you look at the requests they made, they were really quite detailed questions that I think any consumer business that is handling consumer data should take note of. The Bureau asked a lot of pointed questions about how consumer data is harvested, used, shared and monetized. And those are themes that we're seeing a lot of. They're very going to be very focused on that. And I expect them to try to make some kind of UDAP claim around those consumer data usage issues.

Michael Gordon:

The junk fee announcement was a broad, and I would argue very poorly defined initiative that had a lot of pejorative language and was very savvy press move. But in terms of the actual regulatory impact of that, it remains to be seen. They're certainly going to be asking more questions about fees and fee structures, and it's a good opportunity to review your fee structure. They highlighted a few things that are particularly of note to them, like convenience fees, like fees that only show up at the end of a process, therefore arguably a consumer couldn't factor into the pricing at the time of product choice and that kind of thing. And I think next steps on that was we'll see some more use of the bully pulpit to criticize fees and try to get markets to move voluntarily.

Michael Gordon:

And then a few enforcement matters, whether they highlight a fee where there's probably a disclosure problem or something similar. Yeah, here is another example of the importance of the fair lending issue. And that was an announcement where the Bureau said, it's not just the lending decision, but it's the life cycle of the product that can be subject to anti-discrimination laws. And finally, the Bureau has been much more welcoming and encouraging of coordination with state enforcement actors. And I would just point out that a lot of the folks I worked at the Bureau the first time around when I was there, now populate a lot of these state agencies and it makes that coordination all the easier.

Alan Kaplinsky:

Well, we’ve reached the end of our podcast today. I want to thank Mike Guerrero, Lisa Lanham, Rinaldo Martinez, and Michael Gordon, and for covering as much territory as they have covered. Also, I want to thank all of our listeners who took the time to download the podcast today. That completes our program for today and I hope all of you enjoy the rest of your day.