Consumer Finance Monitor (Season 7, Episode 51): Banks Are Over-Supervised and Over-Regulated

Speakers: Alan Kaplinsky, Joseph Schuster and Raj Date

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly show brought to you by the Consumer Financial Services Group at the Ballard Spahr law firm, and I'm your host, Alan Kaplinsky, the former Practice Group Leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr. And I'm delighted to be moderating today's program. For those of you who want even more information, don't forget about our blog consumerfinancemonitor.com. We've hosted our blog since July 21st, 2011 when the CFPB became operational, so there's a lot of relevant industry content there. We also regularly host webinars on subjects of interest to those in the industry. So to subscribe to our blog or they get on our list for our webinars, please visit us at ballardspahr.com. And if you like our podcast, please let us know about it. You can leave us a review on whatever platform you use, be it Apple Podcasts, YouTube, Spotify, or any other major platform. Also, please let us know if you have ideas for other topics that we should consider covering or speakers that we should consider as guests on our show.

Well, the genesis for the podcast show that we're going to be talking about today was an article that I read maybe a month or so ago in a new online publication called Open Banker, and the title of the article is Banks Aren't Over-Regulated, They Are Over-Supervised. And the article was written by a friend of mine who I've known for many, many years who... And I'll tell you a little bit about his background, but I certainly can't do justice to all the accomplishments of our special guest today. Our guest is Raj Date.

Let me give you just a brief description of Raj's background. He's the managing partner of Fenway Summer, an investment firm focused on financial services and financial technology. He's also a co-founder and senior advisor at the financial services advisory firm, FS Vector. Before Family Summer, served in a variety of roles at the Consumer Financial Protection Bureau, the CFPB, including he was the acting head of the agency and its first ever deputy director, and that's when I first made Raj's acquaintance.

Well, Raj, it really is a special privilege for us to have you on our podcast show, so thank you very much for joining us today and I can't wait to delve into your article.

Raj Date:

Well, thank you very much, Alan. Thank you for the invitation and I can assure you that the honor is all mine. And I very much appreciate the leadership that you and your colleagues have had in this sector for these many years, both in terms of the practice as well as, of course, the long-running blog and the podcast as well. So it's great to be here and thank you.

Alan Kaplinsky:

Thank you, Raj. And let me also introduce another guest who is a colleague of mine at Ballard Spahr, and that is Joseph Schuster. He is a partner in the Denver office of Ballard Spahr. His practice involves advising on state and federal laws relating to credit, payments and deposit products. Joseph also regularly advises banks and non-banks on navigating the examination and unfortunately for some of our clients, the enforcement process typically involving the CFPB. Joseph rejoined our firm earlier this year after spending eight years at Goldman Sachs where he was responsible for advising on FinTech and consumer finance activities.

Joseph, always a pleasure to have you back on our podcast show.

Joseph Schuster:

Thank you, Alan. It's wonderful to be here. Raj, I very much enjoyed your article and I'm looking forward to discussing it with you.

Alan Kaplinsky:

Okay, so let's launch into it. So I'm going to give you a real softball at the beginning, Raj, and that is what gave you the inspiration to write this article about banks being not being over-regulated, but being over-supervised?

Raj Date:

Alan, it's mostly because I'd been spending a fair amount of time with people other than bankers. This may shock you to learn, but I do know some normal people in life, so people who have not steeped in themselves in decades around the banking business and all of its attendant regulatory obligations and the supervisory apparatus. And what I encountered over time, particularly coming out of the 2023 mini crisis, when non-bankers, as you might imagine, had some curiosity about the banking regulatory and supervisory regime for the first time in quite some time, I found that some of the things that we take for granted or have gotten used to within the banking sphere really strike other smart professionals outside of banking as quite weird. Some of the things that we have tacitly embraced as necessary features of the supervisory apparatus, so for example, the fact that supervisory information is confidential, must not be shared under penalty, under criminal penalty, potentially, the fact that the supervisory cycles between say a first day lettering exam and the ultimate publication and sharing of results can take not weeks or months, but quarters or years in some cases.

So the fact that things are secretive and lagged and especially really quite unbelievably invasive from the point of view of a non-banker, I thinking about, well, are we just too close to this? Has it been too long that we've questioned, gone back to first principles and thought, well, is this really working? And if not, what should we do about it?

Alan Kaplinsky:

Okay, well I'm really pleased that you put pen to paper. Raj, at the beginning of the article, you discussed the many meetings that you've had with bank CEOs over the years and they would often gripe to you about the fact that banks are over-regulated. You thought that the CEO's reaction was bizarre because banks are the beneficiaries of an array of government privileges. Things like subsidized leverage through insured deposits, liquidity through the discount window and the federal home loan banks, to payment rails through the central bank and bank-only private networks, and even choice of law through federal preemption, either broader federal preemption for national banks and even preemption for state charter banks when it comes to usury laws.

You then conclude then light of all these benefits, safeguards on capital, liquidity, credit exposure, market and interest rate exposure, cybersecurity, it seemed like consumer protection seemed like a fair trade to you. From that you conclude the banks are not over-regulated, but they are quite dramatically you say over-supervised. Are you serious in saying that banks are really not over-regulated by the CFPB or you really just saying that over-supervision is a more serious problem than over-regulation?

Raj Date:

Yeah, I think if I had 10 units of energy to devote to the problem of making banking and bank regulation and supervision more efficient, I would spend 9.9 of those units of energy on supervision and 0.1 on changing, reforming regulations, making things better and more tightly suited to circumstances. That's because I think that by and large, the difficulties that you see in the system are not driven by what, they're not driven by the what is the specific level of capital, what is the specific standard for liquidity for any given firm, what is the mode of interaction from a consumer protection point of view when you do collections? I think it's seldom the what that is the problem. The problem is the how. The problem is how it is that we have chosen to be able to monitor the compliance with the various rules and regulations over time. And we have landed in a spot that is obscure and slow and not especially helpful in the moment, which is a real shame because to me that's something that supervision really had ought to be able to do.

Alan Kaplinsky:

Right, right. A little bit later in our program, we've got, as I said, Joseph Schuster is going to be on and he will try to make the case that banks and non-banks for that matter are way over-regulated, particularly when it comes to the CFPB. But before we get to that, let's turn now to the thesis in your article where you focus more on this over-supervision of banks rather than the under-regulation of banks. You say in the article under the caption supervision 101 that it's difficult for non-bankers to appreciate the sheer magnitude and invasiveness of the supervisory process. You touched on that a little bit when you talked about what inspired you to write the article. I'm wondering if you could explain a little bit more of what you meant there, Raj.

Raj Date:

Sure. What I'm referring to is something that's going to be very familiar to people who have spent any time around regulatory or compliance processes within banks and will seem quite unusual and bizarre to people who have not. So specifically I'm referring to the fact that typically you end up with something like dozens or scores of examiners on the ground at regional and superregional banks in any different exam cycles. You have document requests for... And I mean that literally PDFs of documents that number in typically the thousands to tens of thousands and you have a total system-wide expense between examiners themselves, the oversight provided upon them and all of the lawyers, consultants, internal compliance people required to respond to examination processes. You tally up in an honest way the expense of all that, you end up with a number that looks like it's in the tens of billions of dollars, which is quite jarring.

And I think that should cause anyone to say, "Whoa, are we really getting what we want out of this gigantic and expensive use of time?" And I think the answer would be yes, we would feel very good about that provided that the supervisory efforts were focused on the most important issues, provided that were providing the output was going to give bank management teams and bank boards useful, practical, pragmatic feedback on a timetable that's meaningful and that we don't have better and more efficient means to the same ends. And I think that we have to look at the state of bank supervision today and say that you can't really be confident that those ends are being achieved. And certainly, you shouldn't feel good at the amount of expense and effort that goes into getting those subpar results.

Alan Kaplinsky:

Yeah, but would you say that at least one goal of supervision ought to be protect a calamity that is protect the government because of FDIC insurance and to protect consumers and against an out-and-out failure of a bank? I know this is a big but that I'm going to lay on the table and I'm going to say but for the fiasco that occurred in March of, it wasn't last year, it was two years ago, I guess. Time, it's really about a year and a half ago with Silicon Valley Bank and a couple of other banks that failed very, very rapidly. And I know that's probably, you're going to say it's because they failed because at least in part because the government was focusing on the wrong thing. They weren't looking at the interest rate risk that these banks were dealing with.

But putting them aside, that's the but for, I would say in general, would you agree with the statement that by and large, the banking industry has remained safe and sound for the last several years? It's not like the last time there were major, major failures were several years ago, so somebody might say, "Well, aren't they doing something right?"

Raj Date:

Sure. I mean, the number of bank failures has been, historically speaking, very low and one should feel good about that. But I think it's useful just to pause on exactly what you said is that the main purpose of the supervisory regime is to make sure that banks don't fail in ways that are going to be super destructive outside the four corners of their institutions. And that's just different about banks than most other firms. I mean, bank failures create externalities that, as a society, we really should want to avoid. But if that is your focus, well, then your supervisory efforts should, I would think, be focused on absolutely the most material things that individually or in aggregate could cause the failure of institutions. That really is what Prudential safety and soundness regulation should be about. And if instead we're focused on a bunch of other things, my observation about regulatory agencies and having had the privilege to lead one for a little while, they're just like other professional services organizations, and if they don't focus on the right stuff, you should absolutely expect bad results.

I mean, the Silicon Valley Bank example is a good one. I mean, at the time of its failure, that bank had 12 MRIA, so-called matters requiring immediate attention, exactly zero out of 12 of which had to do with interest rate risk. And if that isn't a clear sign of missing the forest for the trees, I don't know what else is. And although it's very hard to put your hands on concrete data because bank supervisor information is confidential, I would be very surprised if this missing the forest for the trees phenomenon is not more pervasive than we might otherwise like.

Alan Kaplinsky:

Yeah. In your article, I thought it was interesting that you refer to the supervisory mentality as being a check-the-box kind of thinking, that supervisors have lists of things that they have to look at. And it seems like some of the things are important, some of them are maybe a little bit important, some are not important at all, but they've got to look at everything. Tell us a little bit more about what you mean there, Raj, the check-the-box.

Raj Date:

Yeah. Well, one, I start with the most sympathetic view of this that I can muster, which is that we as a society probably don't want strategic and tactical decisions being made for private sector firms by government agencies. That would be a weird way to run a private sector economy. And perhaps born out of that, that is to say this notion that, well, we as examiners shouldn't be telling a bank what to do, there's instead been very much a focus on not so much the substantive what to do with the business, but rather the process by which you do it, and indeed the process by which you are sure that you are complying with the law.

And this, in my experience anyway, and frankly the experience of practically every banker that I talk to is that it devolves over time into a process-mad, process-obsessed approach to supervision such that what examiners end up spending their time on is checking individual policies and procedures, checking the mechanisms and processes by which those procedures are monitored by compliance functions, checking the means by which internal audit functions prioritize their time versus what compliance has already determined, and then, on top of all of that, ensuring that documentation is in place with respect to each one of those steps. And I think in plenty of cases that might be important if you want to be running a disciplined and operationally efficient firm, but that doesn't mean that all of those things are material to the safety and soundness of the institution and you shouldn't therefore be diluting your efforts for the sake of looking for everything that's perfect.

And to his credit, the acting comptroller in a speech, what is it now a couple months ago, pointed to exactly this kind of phenomenon that if you are in a check-the-box mode, you have a whole bunch of processes you need to check and make sure that they're okay, you end up, whether intentionally or not, probably not, but you inevitably end up treating all of the checkboxes as somehow equal, like having parity in terms of importance. And that just is not the world that we live in. Some things are more important than others.

Alan Kaplinsky:

Yeah, no, I definitely see what you're talking about there, Raj. I'm wondering, I want to just get back to the expense of having to go through a supervisory exam. And I'm wondering, is there any empirical data that you're aware of that quantifies what the expenses for a small bank, medium-sized bank, a large bank, or is your conclusion really just based on your experience?

Raj Date:

I think you'll find that each of the trade associations, at least those ones of some size around the banking business, do periodic surveys where they try to calibrate overall expense within institutions. And then not all of the agencies are equally transparent about the size and compensation, for example, of their supervisory workforces, but it is possible to stitch these things together in a mostly empirical way to get to at least an order of magnitude estimate on expense.

What that does not account for though, and I think that we ought to bear in mind, is that it's not just the dollars and cents which are staggering in aggregate, but it's also the fact that senior executives, line of business managers and even boards of directors, as a consequence of this very process intensive supervisory apparatus, end up spending a lot of time, and even more important, attention, on how it is that they are gearing up for exams, how it is they're structuring remediation efforts oftentimes on relatively small board issues, how it is that the various first and second and third line and examination teams are interacting together from a process point of view and bandwidth matters. If you're focused on a bunch of relatively small board process issues as a bank board of directors, well, then you should not expect that you're doing as good of a job at observing the market, listening to your customer, designing products, structuring technology platforms, and executing against operational excellence. You can't do everything, and that's as true with big firms as it is at small ones. And so I think we be both a financial as well as a very important non-financial strategic impact.

Alan Kaplinsky:

Yeah, there's been a lot of criticism lately of the banking agencies, particularly the CFPB, for being, I guess you could say technology-phobic, afraid of technology, afraid of AI. And I'm wondering whether the mentality that you've described, it's so well ingrained in all the federal banking agencies and now the CFPB that that's part of the problem, the check-the-box mentality, they can't figure out what boxes to create to deal with technology. It's such a massive thing and it not touches upon just about every aspect of banking. And I'm wondering if that may be what I've described as the problem or is it something else? And I realize we're getting a little bit off-subject here. You didn't talk so much about it in your article, but it struck me as you were describing the check-the-box mentality that that's part of the reason why they don't seem to be in the mood for encouraging innovation.

Raj Date:

Well, I think there's probably two or three things at work. One, to give credit where it's due, like in a overall economy and information economy that is rife with cybersecurity disaster, seemingly at every turn, you got to admit that the US banking system is pretty darn resilient and pretty darn secure from these risks that are so manifest in other parts of the sectors. And that's not by accident. I mean, everybody knows that it matters, and that's in part due to the structural advantage that the regulators have at being able to look across institutions and be able to export sound practices and share information hopefully in a timely way. And so that's a real success story. But in other areas where you have technology creating entire potential domains of product and conduct, for example, that didn't really exist as recently as 10 or 15 years ago, then, in your phrasing, you don't even know what box to check. The very hyper stylized, hyper structured approach that we have to bank examination and compliance works your disadvantage in an environment that is necessarily more fluid and more dynamic, more changing than it was before.

Alan Kaplinsky:

Right, right. Toward the end of your article, this is another thing that I found a little bit amusing and it really resonated a lot with me. Under a caption entitled Mother, May I, you say that today's supervisory approach encourages a sclerosis and what should otherwise be a dynamic in innovative banking sector. Are you saying that this approach, and this is really similar to the last question I asked you, but that it stultifies innovation or are you saying something else?

Raj Date:

I think that, in general, this approach to supervision has the effect, if granted probably not the purpose of slowing down decision-making cycle times and putting sand into pretty much every gear available in terms of the executive governance of banks and in a competitive environment where there are still manifestly unmet needs and things that we could be doing better as an industry in financial services, having a bunch of sand in the gears is not necessarily the best approach. You shouldn't have executive teams whose first and last question about potential product changes or pricing changes or distribution strategies, their first and last question should not be, what will our line examiners say about this? That's a weird way to run an institution and you shouldn't expect great results.

What you should instead expect is, A, very slow results, and B, a steady homogenization of the strategic approach of all banks in the system. I mean, there are plenty of people who wonder, "Why do we have 5,000 plus banks in the country again? What is the point of that?" And you could have a debate about what the right number is, but if you're going to have that many banks, presumably one of the benefits is you have a real strategic heterogeneity. But if everybody is doing this meta questioning ahead of time of, well, how does this fit into the process of supervision? You shouldn't expect productive strategic heterogeneity. You will iron it out. And that's a real tragedy.

Alan Kaplinsky:

Right. You also mentioned another thing that I think is important. You refer to that this process can lead to a brain drain for banks that highly qualify people who might otherwise want to be employed, want to lead a bank or be in leadership, that the attractiveness of working for a banking institution is diminished.

Raj Date:

I think so. My worry, Alan, is that it's even worse than brain drain per se, so much as the brains aren't really entering the system to begin with. When I think about... When I got involved in the industry, the banking business where success should be about being smart about business strategy and customer and community needs and psychology and technology and finance, all that should be fun. It should appeal to your desire to help people and to help businesses do more to thrive. And it should be dealing with the very real substantive risks. It shouldn't just be obsessively focusing and meetings that are too long with too many participants on a bunch of process-related details. And pound for pound, as a result, you shouldn't expect to be able to track the same level of people with the same entrepreneurial spirit and zeal for results then you would otherwise. And I think that's a real problem.

I'm now at the stage in my career that I might be able to happily retire before this becomes a crisis, but if I were 10 years younger, I'd be really, really worried about where are the next generation of leaders going to come from.

Alan Kaplinsky:

So what you've described in your article, you don't really make a distinction among any of the bank Prudential regulators or the CFPB, and I take it from that, that you think they all of them suffer from the same malady. Are any of them doing it better or is it all pretty much what you've described?

Raj Date:

I wouldn't necessarily have detailed line of sight into individual teams from individual regional offices of say the FDIC. But if I were a betting man, and I suppose that I am, I would bet that both the problems with and the benefits of the supervisory regime are more or less consistent across the country and across federal agencies.

Alan Kaplinsky:

Do you think... I'm just wondering now, this is triggered another thought in my mind. When you were at the CFPB, it was very early on, and I assume you were given your very senior position as being acting head and then deputy director, that you were involved in the development of the supervisory process that was mandated by Dodd-Frank. Was any thought given to going in a different direction than the Prudential agencies or at the time was basically, we've got to follow this template that's already out there, we don't have time to reinvent the wheel?

Raj Date:

Yeah, I will admit that this is something that... I won't speak about maybe the bureau more broadly or about other leaders at the time, but for me personally, this was a real miss. We had a date certain by which we were meant to go live, a date by the way that we chose ourselves, which was one year after Dodd-Frank got signed. And on that date there were some things that just had to get turned on. There was no burn-in period that you went from not being responsible for it one day to being responsible for it the next day. And so one was you had to have a consumer response center that was up and running and taking some manner of consumer complaints. A second critically for this conversation is that we had to be ready to be the consumer conduct regulator for banks of over $10 billion on that date certain.

And messing that up felt like not worth the risk. And as a consequence, we, for what in the moment, made a lot of sense, made the risk-adjusted decision to mostly have approaches that felt familiar to the examination core that we were recruiting for the most part from other agencies. And if I had it over to do again, maybe I would be more aggressive, but I want to be fair to myself, to my colleagues at the time, there was a lot to lose on the basis of a speculation.

Alan Kaplinsky:

Final question for you, at least right now is, how do you fix this problem when you've identified what I consider to be a major flaw in the supervisory process? If you had to do it over and you had a blank slate, what would you do?

Raj Date:

Well, it's actually harder than the blank slate problem because these institutions exist, this way of doing business exists and it's across thousands and thousands and thousands of people. And the reality is that these institutions, the regulators are justifiably proud of their approaches to their work, to the importance of their work, the quality of the staff, and the means by which it gets done. And as a consequence, as you might imagine, they are also pretty intensely conservative with a small C, meaning there really has to be a big impulse to be able to change something if it isn't actively on fire.

And remember, maybe this is obvious to everyone, but in the private sector, we have a huge advantage in general because if something isn't working, there is an ever present profit incentive to stop doing it or to do it differently. That's just not a natural feature of government agencies. And as a consequence, you need, in my opinion, very strong top-down leadership to be able to try how to do things, try to do things in a different and a more efficient way.

For example, pick a part of the supervisory universe and design a process to get the same substantive supervisory work done for 75% less bodies and money. And I think a lot would flow from that kind of very aggressive set of aspirations. You can't do something dramatically more efficiently without forcing yourself to be thinking about what do I need to be doing at all. And as a consequence, it would embrace potentially a different mode of working, a different mode of adopting technology and hopefully, longer term, a different and more efficient, more nimble way for the supervisory process to bring to bear exactly what it uniquely can, which is to focus on the right stuff and to focus on it in a way that's timely and useful and protects the system as a whole as well as consumers and businesses.

Alan Kaplinsky:

Would you eliminate the camel ratings that banks are given or would that stay?

Raj Date:

I would not. I don't see something so compelling about eliminating what after all is one of the few, aside from capital ratios and discrete borderline quantitative approaches. There are certainly people who complain mightily about the nature of the management rating in particular about how it can be too subjective and therefore not especially useful in the moment, but I personally haven't spent much time thinking about how it is that the rating system itself had ought to be reformed.

Alan Kaplinsky:

All right. I'm going to turn to you, Joseph. First of all, I've got a bunch of questions for you, but before we get there, do you have a... I mean, you've been heavily involved over the years, both as in-house counsel and outside counsel when you were with us before you went to Goldman Sachs after you rejoined us in counseling clients about supervisory exams conducted by the CFPB and the federal Prudential banking agencies. Do you agree with Raj about the sense that banks are over-supervised, that there's too much of a focus process rather than substance?

Joseph Schuster:

I'm going to break that question, Alan, into two parts. Number one, I agree that banks are over-supervised. I'm not sure that there's too much of a focus on process rather than substance. I might say that there's too much of a focus on both, and that might be a problem with respect to some of the substance, which I know that we'll get into a little bit later. But I think that it is very difficult to be a bank when you enter a supervisory process and not really know where that process is going to go. Some of that has to do with the lack of clarity with respect to what the supervisors are going to expect from you.

There may be, and I like that Raj talked about scores in this podcast of examiners. You have that and you have scores of examiners and they're exploring different paths, different products, things that may have been looked at before. You may be receiving inconsistent advice from exam to exam. You may go through an exam with respect to a product and feel good that you have the processes, you have the procedures, you have the compliance management system to comply with the law and you may feel good about your practices. Somebody may come in later on and say, "Hey, this practice is problematic." I've seen both as outside counsel and when I was in-house, there is tremendous benefit of being prepared for these exams given the nature of this. And this goes to a little bit of what, Alan, you and Raj were talking about of the expense with these exams or the supervision process.

You would not go into a deposition or go onto the stand in a court case without being prepared for that. I think what I've seen is there is the expense of when the supervision or the exam is happening, but the banks that do well in these exams and ultimately I think spend less and are more efficient in the exam process, go through that practice process. They'll work with us and they'll do a mock exam or a compliance assessment to say, "Okay, here are the questions that examiners are going to ask. How are we going to respond to those types of questions?" It is unfortunate. I think that a lot of it does look at process, but I think being prepared for that does help, and looking at the substance as well, but we'll get into my concerns on the substance.

Alan Kaplinsky:

Let's turn out to this over-regulation. Raj said that it doesn't have zero concern about there being over-regulation, but it's very minute compared to over-supervision. And I know you're concerned about both and I'm concerned about both. So let's talk about your experience, Joseph. Do you believe that there is over-regulation of banks and non-banks at the federal level? And can you share with us why you believe that to be the case?

Joseph Schuster:

Absolutely. Yeah, I get excited about this topic. Let me start by saying that I am a believer in regulation of consumer finance products. Consumer finance products have been around for a very long time. You look at Hammurabi's code, one of the oldest legal artifacts that exists. It talks about consumer credit regulation. So consumer credit regulation is something that is necessary for these products. I think though what we've seen, and I would say that there's been a shift over the past, I don't know, decade, 15 years of where things were, we have seen regulation become more complicated, less clear, more restrictive, and that's more restrictive with respect to innovation and access to credit. So I said I believe in regulating consumer credit, I do, but I also believe that consumer credit is a necessary product. It is a beneficial product.

We talked about the banks in the United States and our banking system. I think that our banking system, our financial infrastructure, is something that helps the United States be as successful as it is in many respects, both with respect to consumers and with respect to businesses. I think the clarity and regulation is an important piece that allows us to have that innovation.

Let me take a couple of examples, if you'll. We've seen the buy now pay later as a product. It was a product that I'm not sure that it really existed decades ago, but we've seen an evolution of how people purchase things as they're doing point of sale financing. And that's good. We should have innovation. We're not doing the radio right now. Radio still exists. It's different though. We are doing podcasts. We should have innovation, and banking should be no different. So a buy now pay later product was invented, and it is generally a product that does not have an interest rate. It's repaid in four installments.

A criticism that regulators had of credit cards was that it has a higher interest rate and it takes a very long time to pay off. Here you have a product that solves those problems. There's no interest on it and it's repaid over a very short period of time. So why is it a bad product? But we get to then the changing landscape of regulations as well. And we see regulation through enforcement, regulation through blog posts, the shifting, inconsistencies of regulators early on, the CFPB had in blog posts that BNPL products were not subject to Reg Z. Then they came up with an interpretive rule saying BNPL products, we interpret Reg Z such that they are included in Reg Z, and therefore all of these things apply. And I'm not sure if anybody read what those things are and how they could apply because it was a mess for the industry. And this was a final interpretive rule. This was not a proposal, "Hey, industry, have some comment. Let's figure out how this will work." It was a final interpretive rule. And I think then the CFPB said, "Oh, look at all these things that we said applied." They came up with an FAQ through a blog post for how you can comply with those things.

So there's a number of things out there. I could go into a lot of examples. I won't for the interest of time, but late fees skipped a lot of the process that were discussed in the Card Act for how late fees need to work. What is that going to do if late fee rules take effect like they're done? It's going to restrict access to credit for individuals. Does that need for credit go away? Absolutely not. What it will do is it will shift where people go for credit and it'll require people to go to a higher cost credit alternatives. And I'm not sure that that should be what regulations are causing in the banking system.

Alan Kaplinsky:

Yeah, and I guess another very recent example would be earned wage access. Another product that consumers love. It can be cost free if it is handled properly, but yet it's now subject to very heavy regulation at the federal level. Right?

Joseph Schuster:

Right. The contract circular is another one. It's a circular now, not even interpretation, just a circular coming out saying, "We don't like these types of provisions in consumer contracts." It makes it for a very difficult, highly regulated area. And I don't think that it is difficult for banks to know what the case is going to be. And we see this through the supervision process as well. That's why I agree with what you and Raj were saying. In the supervision process, we will hear from different examiners that you cannot have a one-payment product that has electronic funds transfer. That's not what the EFTA says, but they don't like that. We hear that consumers need to have the choice of not paying on their credit or not applying refunds to their credit that consumers could then choose not to pay your product and pay something else. These are all new inventions from different supervisors, different agencies. It creates a very difficult landscape for banks to try to comply with.

Alan Kaplinsky:

So what do you think should be done Joseph to cure this problem that you've described?

Joseph Schuster:

That's a great question. I think that, in some ways, we have a lot of the answers in existing law. I think that there has been a demise or disdain for the Administrative Procedures Act. I think if we started following that, if you look back, the Card Act was a law passed by Congress, and then the Federal Reserve Board created a lot of proposed regulation and then final regulation. There was a lot of interaction through the notice and comment period that the Federal Reserve Board had with the industry. What were the effects of the different provisions going to be? How should they be implemented? Some of those provisions were delayed as a result of that process.

If that process is engaged and done so in a manner that is not perfunctory, I think we see today that regulators have a conclusion. They want to get to something and they follow things from a process perspective. And I guess this goes back to what you all were talking about, about too much of a focus on process as a result of the actual engagement and the substance behind things. I think that if there is that engagement about how things are going to affect consumers, how they're going to affect the industry, how they're going to affect innovation, I think that we will be able to solve this problem. We will be able to have more clarity. We will know the effect that things are going to have on consumers and consumers access to credit and how banks are going to comply with those regulations.

Alan Kaplinsky:

Right. The problem with over-regulation, I mean, Raj has described quite well the problem with over-supervision, the problem with over-regulation, I take it is that it prevents companies from moving as rapidly as they would like to move. They become afraid of their own shadow. They feel like anything that they do is going to be second guessed by the whatever agency is supervising them. Have I identified that correctly or are there other things other than what I've described?

Joseph Schuster:

I think you have, Alan. Yeah. As I look, Raj, at your article, I think that there's a lot of things that you have in here about the downfalls of over-supervision that I think also apply to over-regulation. You have in here, and I quote, "Left unchecked, this can lead to distressing monoculture of bank strategies." I think that over-regulation can lead to that as well. We are stymieing the ability to be innovative, to provide credit for people who need credit. We've talked about the number of banks that this country has. That number has been decreasing. As compliance costs continue to increase, we see consolidation. As we have consolidation, we have less innovation, fewer choices for consumers. Those are not good things for consumers. They're not good things for banks.

Another thing that's, Raj, in your article, you talked about giving banks a clear understanding of the rules of the road. I think that's important for supervision and it's important for the regulations. And I think that it would make the supervision process easier if banks and the examiners understood and regulations were much more clear about what banks needed to do.

Alan Kaplinsky:

Yeah. The other thing, it strikes me that when Raj, in his article, he captions one section, Mother, May I, and that really resonated with me because so often in my practice over the years, I would get calls from clients who they would describe to me a product that they're working on, and then they would say, "Does it violate the Truth and Lending Act, the Electronic Funds Transfer Act? Is there any problem that you see here at all?" And I would very often say to them, "I think it's in perfect compliance with the Truth and Lending Act. I think all what the so-called Enumerated Federal Consumer Financial Laws, it complies with all of them. However, however, I don't think the CFPB is going to like what you're doing here. Why? Because they have this UDAP authority, the authority to regulate unfair, deceptive or abusive acts or practices. And it's a very vague authority. It's not crystal clear."

It's like they used to say, "Who was the..." I think it was the Supreme Court Justice who said, "I know pornography when I see it." Okay. Well, I think the attitude of a lot of the regulators is if something doesn't look right or I don't like it, I don't like what they're doing, then I will shoehorn it into UDAP. And so often clients of mine have abandoned ideas for products that I think would've been very good, but it's the Mother, May I. And the answer too often is, no, you can't. Not under the system that we have.

Joseph Schuster:

Right. I mean, a great example of this, Alan, is the contract circular where the CFPB through their UDAB authority is saying there's a number of provisions in contracts that the CFPB simply does not like. These are provisions that are in most consumer credit card contracts today.

Alan Kaplinsky:

Even in contracts, government contracts, right?

Joseph Schuster:

Exactly, right. Government, mortgage contracts, all of these things have these terms. But then one day they decided, we're going to publish this circular. That is a very difficult environment for a bank or a non-bank to work in and to try to innovate in. And it's a difficult world for an examiner to operate in as well that you can get lost on the process, I think, because where things are from the substance are less than clear.

Alan Kaplinsky:

Right. Raj, what's your reaction to what you've heard from Joseph? Does it move the needle anymore or are you still saying supervision is still the main thing we need to worry about not over-regulation?

Raj Date:

Well, as I am prone to do, I will reframe Joseph's argument in a way to make it seem like he's agreeing with me. I would describe a lot of the problems that Joseph refers to is what I call the supervisioning of rulemaking. In other words, it seems to me, it would be useful to remember that agencies have an array of tools at their disposal. They have the power of just persuasion and using the bully pulpit. They have the ability to inculcate financial education in ways that don't exist today that can respond to complaints. And maybe most critically, they are able to enforce the law for violations of the past. They can respond through supervision about conduct in the moment, and then they can use APA rulemaking to change the rules of the road going forward. And I think a lot of the difficulties that we end up in is confusing the past, present, and future to the extent that you're trying to change the rules of the road to do so in an intentionally not especially transparent way through supervisory guidance and things of that ilk is pretty ill-suited.

Similarly, if what's really at issue are large material infractions that have caused consumer harm in the past, in my opinion, the enforcement tool is the best for that. Not supervision, but because supervision can be quite a bit more nimble, I feel like we end up defusing its impact and approach, especially into forward-looking territory that really should be the province of rulemaking in the view of most.

So to that end, I certainly embrace this. And again, guys, I really appreciate the chance to talk with you and to your listeners about this. I think it's a real issue and it's not going to solve itself on its own.

Alan Kaplinsky:

Yeah. Well, thank you, Raj. And we have come to the end of our program. I'll give Joseph, do you have any final remarks that you'd like to make?

Joseph Schuster:

I think it's a very valuable podcast. Raj, I thank you for joining us. I think your article is spectacular. I might have changed aren't to are over-regulate, but other than that, I think it's wonderful and I really enjoyed the discussion today. So thank you.

Alan Kaplinsky:

Yeah. Okay. My thanks to both of you.

To make sure that you don't miss any of our future episodes, subscribe to our show on your favorite podcast platform, Apple Podcasts, YouTube, Spotify, or any other major platform you use. And don't forget to check out our blog, consumerfinancemonitor.com for daily insights on the consumer finance industry. If you have any questions or suggestions for our show, please email us at podcast@ballardspahr.com. Stay tuned each Thursday for a new episode of our show. Thank you all for listening and have a good day.