BEACON
POLICY ADVISORS

1701 Pennsylvania Ave, NW
Suite 200
Washington, DC 20006
beaconpa.com

SPOTLIGHT REPORT

June 15, 2023

The CFPB's Robust Regulatory Agenda

What's Happening: The Consumer Financial Protection Bureau (CFPB) has released its updated regulatory agenda as part of the larger Biden Administration Unified Agenda of Regulatory and Deregulatory Actions. Included among the proposals are a new rule to regulate large market participants in the payment system, which would likely include **Apple (AAPL), Block (SQ), PayPal (PYPL), Amazon (AMZN), Meta (META),** and **Alphabet (GOOGL)**. There is also an updated timeframe for finalization of the credit card late fee rule and the "open banking" rule, as well as estimated timelines for initial proposals for regulation of not sufficient funds (NSF) and overdraft fees.

Why It Matters: The payment system rule is possibly the most aggressive CFPB action taken during the Biden administration as it would subject some of the largest US tech companies to the bureau's supervision and examination. It also indicates that the CFPB will continue to play hardball in its efforts to prevent the development of a so-called "super app" such as those used in China (**WeChat (TCEHY) and Alipay (BABA)**). The credit card late fee rule had been the most controversial of the bureau's activities, but most observers have already digested what it means for financial firms and some companies, such as **Synchrony (SYF)** having already laid out their plans to offset any lost late fee income. The rule is also certainly going to be litigated, so it is unlikely to take effect when the bureau hopes, although investors and companies should not pin their hopes on a positive court outcome and it is only a matter of time before these fees are dramatically reduced – although in the short term, this largely depends on whether President Biden wins reelection. Finally, the open banking rule, although

more of a long-term project, is meant to empower consumers to switch financial services providers in an easier manner, creating more competition and incentivizing new market entrants. **Taken together, these rules seek to put the CFPB at the heart of the emerging financial system as the arbiter of the rules with an ability to shape business decisions and investment for years to come.**

What's Next: The payment rule is listed in the Unified Agenda as being proposed in July, which is likely to happen, since CFPB Director Rohit Chopra will not want to have the rule "lost" to the public or financial markets by releasing it in the "dog days" of August. The credit card late fee rule is also scheduled to be released in July and, as the current priority that is most advanced, we would be surprised if this timing slipped. The open banking rule is on track for release in October and we expect this to happen, although there will be a lengthy implementation period. The NSF and overdraft rules are lower priority for the bureau and those are penciled in for release as proposed rules this November, although this timing could slip if the other rules are delayed, but any finalization towards the middle to end of 2024 could put a rule in jeopardy of being overturned by the Congressional Review Act (CRA) should a Republican win the White House and Congress flips to unified Republican control.

Unified Agenda Rulemakings

Twice a year the Office of Management and Budget releases what it calls the Unified Agenda, which is a compilation of all of the intended rulemakings across the federal government and the various stages of the notice and comment process they are in. The most recent Unified Agenda came out earlier this week and it contains 11 rulemakings from the Consumer Financial Protection Bureau (CFPB), although we believe only around five of them are of considerable interest to investors.

These rules are officially entitled, "Supervision of Larger Participants in Consumer Payment Markets;" "Credit Card Penalty Fees;" "Required Rulemaking on Personal Financial Data Rights;" "Fees for Insufficient Funds;" and Overdraft Fees."

Payment Companies

Although the CFPB has not yet provided any details to help ascertain the full scope of the proposed rulemaking, we expect a primary focus of the CFPB will be on using its supervisory powers to prevent any payment system company from creating what is commonly known as a “super app.”

The bureau vaguely describes the yet-to-be proposed rule in the following manner:

> Under section 1024 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the CFPB is authorized to supervise certain nonbank covered persons for compliance with federal consumer financial laws and for other purposes. Under section 1024(a)(1)(B) of the Dodd-Frank Act, for certain markets, the supervision program generally will apply only to "larger participant[s]" of these markets as defined by rule. The CFPB has defined larger participants in several markets and is considering issuing additional regulations to define further the scope of the CFPB's nonbank supervision program. **In particular, the CFPB is considering rules to define larger participants in markets for consumer payments [emphasis added].**

While this is an overly bureaucratic and jargon-filled entry, what it says is that the bureau has legal authority to regulate the largest participants in consumer finance markets and that it is going to choose the largest players in consumer payments for regulation. Importantly, **these firms currently are not under any specific federal financial regulatory supervision nor do they have any separate or specific prescribed federal rules.**

While there will eventually be new rules that govern the conduct of the companies in this sector, investors need to be ready for their supervision and what that entails. Supervision by the CFPB is akin to what banks have to go through with their primary federal regulator. **There will be onsite examinations of the company’s business practices, access to proprietary data regarding how the company acts as a payment provider, as well as to internal strategy documents about the direction of the company as a payment provider and how this may impact consumers.**

To use the example of **Apple (AAPL)**, it creates hardware and manages the App Store and access to apps that are run on Apple hardware. It has also moved into payments via Apple Pay and into lending via Apple Pay Later. **To the extent that it has other strategic expansion plans in consumer finance, we expect that the CFPB will carefully scrutinize and could even try to block Apple from developing its products any further into a super app.** While there is no certainty that Apple intends for this type of maturation or that the bureau would target Apple over another company, supervision is a more intrusive type of regulation compared to what most of the largest payment companies have had to endure thus far.

Another example of how the bureau could create risk via supervision for a payment provider is **Block (SQ)** and its expansion into crypto and streaming music, as well as its more traditional CashApp product. **We could easily see the CFPB taking an interest in how Block uses sponsorship in streaming music to cross market CashApp to its mainly racial minority customer base and is encouraging these same customers into the crypto markets when that may not be their best financial choice (at least in the opinion of the CFPB).**

Across all of these payment providers, we expect that the bureau will take issue with the manner in which the companies allow consumers to keep significant sums of money in their app-based accounts without Federal Deposit Insurance Corporation (FDIC) backing. These sums are effectively free loans to the companies and are not supported with deposit insurance, meaning that if a company were to fail, the money could easily be lost. In an April interview with the Washington Post, CFPB DIrector Rohit Chopra discussed his fears for consumers, particularly low-income consumers, regarding parking their money with peer-to-peer payment companies, such as **PayPal (PYPL)**, **Venmo (PYPL)**, and **Block's CashApp** rather than with banks. Millions of Americans likely do not realize that the money they keep with peer-to-peer payment companies is not insured or regulated like it would be with a bank that has FDIC insurance

While he did not expressly say that he has concerns about any specific company, he did state, "So I think as we see more digital currencies, we see a potential of stablecoins and other money-like instruments, we as the regulators have to stay ahead of the game because we want families and businesses to know that their money is secure from attacks, from runs and instability."

Later in the interview, Chopra alluded to what exactly he meant by "stay[ing] ahead." This would entail the Financial Stability Oversight Council (FSOC) designating payment systems or money transmitters as systemically significant, which would bring companies like **PayPal, Venmo,** and **Block's CashApp** under Federal Reserve Board supervision and entail much more strict prudential regulation, likely including higher mandatory capital levels and stress tests. Specifically, Chopra said, "I have argued that we may need to think when it comes to digital payments and currency of looking at an old provision of law that was also passed in 2010 [the Dodd-Frank Act] that would allow the regulators to designate certain payment systems as potentially systemic, which would allow us to make sure they are safe and sound and protecting consumers."

Our view is that Chopra did not receive very much support from other members of the FSOC when he raised this issue and has decided to proceed to use a CFPB large market participant rulemaking to begin the fight against these companies, not only based on the perceived risk to consumers, but also to regulate a larger payment ecosystem that is moving ever steadily towards a super app.

While behemoths such as Apple and Amazon will likely not have their revenue materially impacted by the CFPB's actions, others, such as Block and PayPal, could face greater financial strain as their lines of business are far less diversified and if the bureau were to stymie their plans after they had expended significant investments, this could result in a bad outcome for these companies.

Credit Card Late Fees

The CFPB ignited a firestorm in February when it proposed a complete rewrite of the regulations governing credit card late fees. The proposed rule goes far beyond what most consumer advocates and policy analysts expected and has provoked vitriolic reactions from various bank trade groups and Republican members of Congress – a testament to how much this rule could negatively impact the credit card lines of business for companies like **Synchrony (SYF), Bread (BFH),** and **Capital One (COF)**.

The proposed rule was announced at a White House event on "junk fees" and the high level of press coverage was exactly what Chopra was seeking. His remarks on the rule can

be found here. Additionally, the bureau released a redline of the new proposal against the existing regulations. Although lengthy, this is a helpful document for investors to see the exact proposed changes rather than relying just on a summary. There is also a document that is the CFPB's analysis of late fee revenues from large banks, but since this data is anonymized, it is of less use to investors looking to identify the companies that would be most impacted by the proposed rule.

In terms of specifics, the rule would make several sweeping changes. First, the "immunity provision" safe harbor is reduced from $30 for an initial late payment and $41 thereafter to $8. The basis for this dollar figure is the bureau's analysis that "late fee income exceeds associated collection costs by a factor of five. Because the immunity provision currently allows issuers to charge late fees of up to $41, the CFPB believes that a late fee of $8 would be sufficient for most issuers to cover collection costs incurred as a result of late payments." It is worth noting that credit card issuers would be allowed to charge over $8 if they could prove the higher fee is necessary to cover their incurred collection costs but this would invite government scrutiny and potential litigation so it is unlikely to be used in the future, just as it is not utilized today.

The automatic annual inflation adjustment is eliminated and the $8 amount would not increase unless the CFPB changed that figure in a future rulemaking. The bureau correctly states that the inclusion of an inflation adjustment was a choice by the Federal Reserve Board and is not required or even mentioned in statute. Next, late fees are capped at 25 percent of the required minimum payment, versus the current amount of 100 percent of the minimum, which the CFPB believes is more consistent with the statute that authorizes "only reasonable and proportional late fee amounts."

The proposed rule also asks several other questions that are not the core of the proposal, but preview some areas where the bureau could have gone (or may still go) even further. One query is whether the proposed changes should apply to all credit card penalty fees and not just late fees. Another asks if the immunity provision and safe harbor should be eliminated altogether. A third asks if consumers should have a 15-day grace period before late fees can be assessed, and a final query addresses whether card issuers should be forced to offer users autopay in order to be able to access the immunity provision.

Taken together, these changes are estimated by the CFPB to save consumers around $9

billion a year out of the $12 billion generated by late fees for card issuers in 2020.

Companies such as card issuer Synchrony have begun planning for how to adapt to these potential changes and are starting to communicate these ideas to investors. Synchrony CEO Brian Wenzel recently was quoted saying, "I think we're probably heading into what I'd say is a more definitive period of time, where we've kind of identified the exact things we may do. It's not necessarily going to be in one flavor, given the size of what the CFPB is proposing." He went on to list three different ways that the company may change its pricing to make up for lost late fee revenue.

The first option is to impose other fees that are mandatory to pay, such as annual fees, although there could be other fees included so long as they were adequately disclosed up front. It is notable that under the CARD Act of 2009, card issuers cannot collect upfront fees that total more than 25 percent of the available balance in the first year.

Raising annual percentage rates could be a second way to generate lost fee income. This could put Synchrony at a competitive disadvantage over other firms, but this type of competition over rates is exactly what the bureau is trying to encourage rather than relying on income from the poorest Americans.

The third option is for Synchrony to use new ways to deter late payments using penalty-based pricing for a consumer's interest rates. This is complicated due to the fact that the CARD Act restricts when this type of change in interest rate can occur, which is at least 60 days later than a missed payment.

Besides these unprecedented fee changes, there is also an important process question that remains unresolved. The banking industry trade groups contend that the bureau was required first to convene a Small Business Regulatory Enforcement Fairness Act (SBREFA) panel and to hold hearings to gather input from small entities that would be impacted by any proposed credit card late fee rule. But the CFPB did not do this and it appears that it does not intend to do so. According to the bank trade groups, the Dodd-Frank Act mandates that "Under SBREFA, the CFPB must convene and chair a Small Business Review Panel (Panel) if it is considering a proposed rule that could have a significant economic impact on a substantial number of small entities."

The bureau has convened such panels in the course of promulgating rulemakings multiple times before and its legal counsel assuredly is well aware of this mandate. Although the likely primary reason for foregoing a SBREFA panel was to expedite the rulemaking process, our expectation is that the CFPB has what it deems to be unequivocal economic analysis and therefore Chopra is comfortable that the bureau can defend in court that a SBREFA panel was not necessary.

It is notable that there have been a few articles recently about the Citi Simplicity card, which has never had late fees and has been helping low- and moderate-income consumers build credit and have ensured flexibility in the ability to meet payment obligations for many years. It is also notable that Citi has removed and created new cards repeatedly over time and the Simplicity card has been steadfast, appearing to indicate that it continues to be profitable.

If a court rules that the bureau's evidence is insufficient, then the rulemaking will effectively have to restart with the convening of a SBREFA panel and then the proposed rule itself will likely have to be amended so that it is more favorable to at least small financial institutions to be able to survive the inevitable follow-on court challenge. In other words, a legal setback on procedural grounds would likely only delay when the rule goes into effect (if President Biden is reelected) and result in changes on the margins, not scuttle it altogether. Comments on the rule as proposed were due by April 3rd, 2023, and we expect the final rule to be released in July.

Another process question revolves around the calculations that the bureau has made to come up with the $8 figure, which is vehemently rejected within industry circles. An analysis from the Washington Post quotes banking industry officials saying that the CFPB analysis was "slapdash" and used data "not designed for this purpose." In response, the bureau said that card issuers "missed opportunities to reveal their costs." "The CFPB's proposed rule seeks to close a regulatory loophole that has allowed credit card companies to charge Americans excessive late fees for over a decade. The proposal is based on an analysis of data that was not available" when regulations on card fees were first implemented more than a decade ago.

The bureau also refutes charges that its analysis to decide the late fee amount of $8 is insufficient by stating for the record that in 2022, the bureau requested "data from credit

card issuers about factors used by card issuers to set late fee amounts and their costs and losses associated with late payments. Card issuers and trade groups did not provide detailed information on the types of costs, and the dollar amount of the costs, they incur to collect late payments."

It will be up to a judge to determine whether the bureau was arbitrary and capricious in its analysis and determination of the $8 figure, but it is clear that the CFPB has the authority to change the rules related to the CARD Act.

Should the bureau be able to prove that the rulemaking as conducted is procedurally sound, then we expect that it will be finalized without material changes and that banks will have to operate under the new standards come next year. Should the bureau lose in court, then it still could effectuate these changes if Biden were to win a second term, although it may have to start over or at least convene the SBREFA process that it skipped and it is unlikely to be able to maintain the $8 fee, although any amount that it was changed to would almost certainly be less than the current fees.

Open Banking

This past October Chopra announced that the bureau was moving forward with its outstanding **section 1033 rules on consumer financial data portability and other safeguards to push financial markets towards an "open banking" model.** He reiterated in a recent blog post his commitment to issuing a proposed rule this summer and finalizing the rule next year.

This specific section of the law says the bureau is to prescribe rules requiring "a covered person [to] make available to a consumer, upon request, information in the control or possession of the covered person concerning the consumer financial product or service that the consumer obtained from such covered person, including information relating to any transaction, series of transactions, or to the account including costs, charges and usage data."

This rulemaking, which is mandated by the Dodd-Frank Act, has been delayed for some time and the first part of the process was the SBREFA panels, which convened last fall. To that end, the bureau has released a series of documents that informed those SBREFA

panels, including an “Outline of Proposals and Alternatives Under Consideration, Small Business Advisory Review Panel for Required Rulemaking on Personal Financial Data Rights,” as well as a “high-level summary and discussion guide” to the aforementioned rule. **The panels met in 2022 and interested parties had until January 25th, 2023 to submit written comments.**

The CFPB is using this rule as a way to try to revamp the plumbing of the consumer finance system to shift it towards what Chopra thinks is a more competitive market for consumers, who will have greater leverage and bargaining power versus their financial services providers. In the press release announcing the start of the rulemaking, the bureau wrote, “By monopolizing the use of personal financial data, financial institutions are [currently] able to block competitors’ access to potential customers and stifle development of competitors’ products and services…This rulemaking aims to create a marketplace where companies would need to improve their offerings to keep their customers. Nascent firms would be able to use consumer-authorized data to build and widely offer products and services that can compete with big incumbents. Consumers could switch providers to get a better deal or escape poor customer service, and companies would have to keep and attract customers through competitive prices, high-quality services, and improved products.”

In essence, by mandating that data must follow the customer and that it is legally required to be shared upon request (but not without specific request), a competitive advantage is being removed from incumbent companies and that, at least in Chopra’s mind, will lead to greater switching between providers and will facilitate the growth of new enterprises which will have reduced costs for customer acquisition.

The rule would potentially cover six categories of data, including:

1) Periodic statement information regarding transactions and deposits that have settled, including fees, account terms and conditions, and the annual percentage yield of an asset account or the annual percentage rate of a credit card account;
2) Information regarding prior transactions and deposits that have not yet settled;
3) Information about prior transactions not typically shown on periodic statements or online financial account management portals;

4) Online banking transactions that the consumer has set up but that have not yet occurred;
5) Account identity information; and
6) Other information, including consumer reports obtained and used by the covered data provider in deciding whether to provide an account or other financial product or service to a consumer.

Additionally, the rule would make personal financial data more secure by likely banning certain practices such as “screen scraping” and holding companies liable for data breaches in the transfer of information. It would also create new limits or outright bans on the secondary use of consumer financial data.

The bureau lists four potential approaches to what it terms secondary uses of consumer data:

1) Prohibiting all secondary uses;
2) Prohibiting certain high risk secondary uses;
3) Prohibiting any secondary uses unless the consumer opts in to those uses; and
4) Prohibiting any secondary use if the consumer opts out of those uses.

It will also likely create a new industry of third-party companies that specialize in services to facilitate these transitions for consumers and the acquiring financial institution. Another potentially more challenging, but hoped for, result of the rule is that underwriting is done with less racial bias and reliance on outside information in predicting a consumer’s ability to repay, compared to their personal financial balance sheet full of actual transaction data.

At its core, the rule is a direct challenge to the so-called “stickiness” between consumers and financial institutions where there is less cross-selling and more reliance on each individual product (credit card, checking account, payment processor, etc.) being appealing. Chopra characterized it in the following manner, “Dominant firms shouldn’t be able to hoard our personal data and appropriate the value to themselves. The CFPB’s personal financial data rights rulemaking has the potential to jumpstart competition, giving Americans new options for financial products.”

One sector with which Chopra chose to compare a reformed consumer finance

marketplace was telecom. His leading example was the Federal Communications Commission's number portability rules, which in his view helped jumpstart competition in mobile phones. Another was the older Carterfone rules that were meant to ensure that the physical equipment of landline phones (plugs, jacks, etc.) were standardized to fit with AT&T's network. Chopra is typically a critic of what was at the time considered to be deregulation, but this positive reaction should be informative of where his views lie in terms of improving choices for consumers.

In terms of what products the rule will cover, **Chopra made clear that the first round of rules will apply to financial institutions that provide deposit accounts, credit cards, digital wallets, prepaid cards and other transaction-based accounts. The bureau intends to expand the rule to more products over time, but the next tranche of products will be informed by how the rules impact the markets for those initial types.** The regulations are also going to include bright lines to prevent incumbent institutions from refusing to share data or misusing it in order to protect their competitive position.

Finally, Chopra discussed how the bureau is looking to safeguard, from the start, any attempt to monopolize, rent seek, or self-preference during the shift to this new process or to exert control over segments of the consumer finance ecosystem. In his view, the more decentralized such a system becomes, the more benefit there will be for consumers and new entrant companies. Chopra used credit reporting and card networks as two examples of highly concentrated markets that he hopes will not be recreated and could even change once this type of open banking system is more widely adopted.

Not Sufficient Funds (NSF) and Overdraft Fees

Finally, that leaves two rules that have long been discussed by consumer advocates, but are generally only for traditional commercial banks and do not have a heavy technology component. For example, if a consumer's transaction exceeds his or her account balance, the financial institution can pay the transaction and charge an overdraft fee, or it can decline the transaction and charge another fee for not having sufficient funds. Some institutions have begun to voluntarily drop these fees, but they still remain significant sources of revenue for many banks.

The bureau would look to impose new limits or potentially ban NSF fees under this potential rulemaking.
As with all of the fee rules, there is nothing stopping the CFPB in trying to finalize its proposals and the fact that many of the largest financial institutions have already dropped their NSF fees will only bolster the bureau's case that they are unfair and unnecessary.

The CFPB is also going to propose a rule to Regulation Z that governs overdraft fees that consumers incur when their account is overdrawn. The rules would likely limit the amount of the fee and more specifically prescribe the circumstances in which such fees can be assessed, limiting their use and this fee as a revenue source for banks.

The bureau does not have to modify its proposals in the face of opposition from Congress and industry and its lawyers expect to be sued for nearly every proposal, so it instead focused on ensuring that its rules stand up to Administrative Procedures Act scrutiny, while still accomplishing the progressive goals of the bureau.

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