How The CFPB Is Crushing Small Lenders

Law360, New York (September 06, 2012, 12:37 PM ET) -- Imagine this 2017 news story:
Congress Expands The CFPB's Reach To Mattress Companies As Nation Endures Severe Mattress Shortage

Sept. 1, 2017--Today Congress passed legislation authorizing the Consumer Financial Protection Bureau to expand its reach to regulate the production and quality of mattresses. After the overwhelming cost of compliance under the Consumer Protection Act and the CFPB's regulations forced credit unions and community banks to shut their doors, the "too big to fail" banks have all merged into two remaining banks, the National Banking League and the American Banking League. The resulting lack of competition in banking has driven prices higher. Those individuals who choose to avoid these high costs of banking have resorted to keeping their money under their mattresses. The CFPB has been increasingly concerned that these mattresses may not be of a sufficient quality material, and the cash may cause lumps in the bedding. The CFPB is therefore proposing that all mattresses be made of a minimum thread count, and that each mattress company produce at least 10,000 mattresses a month. Mattress price gouging — as the CFPB determines in its sole discretion — is expressly prohibited. The CFPB's secret shoppers will now be shopping for mattresses, making sure all mattress tag disclosures ("Not to be removed under penalty of law") are carefully and accurately explained. In related news, Alexander Hamilton rolls over in his grave.

OK, so the Orwellian headline may be a bit far-fetched, but the strain on the nation's financial institutions caused by the soaring costs of compliance cannot be ignored. For the first time in history, smaller community banks and credit unions are facing much of the same compliance costs as the large national banks. There is increasing concern in the market that the increased costs of compliance will force small lenders out of business.

To deal with their increased costs of compliance and their decreased profit margins, an increasing number of small and medium-sized banks and credit unions are merging. The smaller institutions do not have the resources of the larger institutions to hire more accountants and lawyers to manage compliance risks and to absorb those costs. The cost of compliance only seems to be going up — leaving capital investors and consumers to question the viability of smaller institutions.

Entities Covered for the First Time

Because a substantial segment of the entities subject to the CFPB's authority have never before been federally regulated in a meaningful way, the new compliance costs have come on like a rogue wave.

Pursuant to Section 1024 of the Consumer Protection Act of 2010, the CFPB has authority to supervise "very large banks, savings associations, and credit unions," "other banks, savings associations, and credit unions," and "nondepository (i.e., nonbank) covered persons," for compliance with federal consumer financial laws. The CFPB also has the authority to supervise nonbank covered persons of all sizes in the residential mortgage, private education lending, and payday lending markets, in addition to nonbank "large participants" in markets for other consumer financial products or services.

Using its statutorily provided authority, the CFPB has to date defined large participants in the consumer debt collection and consumer reporting markets. The CFPB has further published its proposed rule to supervise nonbank covered persons when the CFPB has reasonable cause to determine that such persons are engaging, or has engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services. The CFPB also anticipates issuing additional rules to define larger participants in additional markets.

In sum, if the entity or person offers any consumer financial product or service to the public, it is within the reach of the CFPB, or should expect to soon be in the reach of the CFPB.

The Shock of Mounting Compliance Costs and Diminishing Revenues

As newly covered entities, the small and medium-sized institutions and nonbank entities have no frame of reference for determining compliance costs. Many newly covered entities are having to develop compliance policies and procedures for the first time. As the CFPB is continuing to release its proposed rules, there are also proposals to limit the CFPB's authority. Accordingly, it is a constantly changing landscape as to whether certain entities are subject to the CFPB's authority, and if they are, the extent to which the entity is governed.

Newly covered entities have to deal with these constantly changing compliance requirements while simultaneously conducting business. This constant state of flux effectively requires that a covered entity or a possibly covered entity have someone constantly monitoring the regulatory and legislative developments. The regulatory guidance in some instances is more than 1,000 pages long. Such a person costs money. If you are a small lender, you are forced to choose between a new revenue-generating loan officer, or a new compliance officer to read all of the materials the CFPB generates.

Covered entities are also facing additional costs for a hodge-podge of newly required services. For example, the CFPB's proposed rules require that mortgage lenders: provide a copy of appraisals, cover the cost of additional appraisals in certain circumstances, provide copies of the consumer's credit report relied upon in making the credit decision, absorb the costs to monitor whether an appraisal fee is "reasonable and customary," absorb the costs to monitor the compensation of the CEO, as well as monitor the compensation of loan officers, absorb the costs of compliance inspections to prepare for "secret shoppers," absorb the costs for no-fee loans in certain circumstances, and absorb the costs of providing mandatory loan modifications. Should the entity fail to properly monitor and apply any of these new regulatory requirements, it may also be faced with the costs of settling state and federal regulatory fines and actions.

As if the soaring cost of compliance was not startling enough, covered entities also have to face the daunting task of answering to two bosses. The state attorneys general, in addition to the federal regulators, have the authority to enforce consumer protection laws. State agencies can also revoke a state-chartered entity's license to operate in that state. Thus, this dual compliance requirement can put covered entities in a precarious position if the state and federal agencies have different supervisory philosophies and expectations.

In the past, smaller institutions preferred state regulation, because state assessment fees were less expensive than federal charters, and the state regulatory regime was seen as more friendly. No more. A provider of consumer financial products or services may now be viewed as a state regulator's cash cow, if the state decides to bring an enforcement action and levy fines and penalties.

While absorbing these new regulatory costs, covered entities are also limited from taking advantage of certain revenue sources. For example, certain covered entities may no longer offer credit insurance, include arbitration clauses in their consumer contracts to assist with limiting legal costs, and must implement a mandatory reduction of interest rates for up-front payment of certain fees.

At the end of the day, smaller entities find that they are operating on a nonexistent or fairly thin profit margin.

No Rest for the Weary

Most covered entities want to operate an honest and financially sound business. A brief glance of industry newsletters and articles indicates the dire shortage of qualified compliance officers. All size entities — from the largest national banks to small community credit unions — are in need of qualified compliance officers. There simply are not enough people with experience available, and even those with experience as compliance officers are faced with newly released rules and regulations on a sometimes weekly basis.

Nonetheless, the current regulatory landscape does not make it easy for covered entities to comply. There is no structured way for covered entities to seek clarifications or guidance from the CFPB regarding the new rules and regulations. Covered entities worry they will raise a red flag to the regulators if they admit the requirements are less than clear. The last thing a covered entity wants to do is announce, “hey regulator, we are not compliant, and have no idea how to become compliant. Come investigate us.” The penalties for noncompliance are too high for the covered entities to risk the chance of a regulatory civil investigation demand.

Is Relief in Sight?

Some states are starting to take notice that the burden of the new regulations is crushing small, community-based financial institutions. Thus, lawmakers are starting to look at the cumulative effect the regulations are having on the economy, and whether the regulations are acting as a roadblock to economic recovery. Rep. Shelley Moore Capito, R-W. Va., chaired a House Financial Services subcommittee hearing to determine how the new regulations are affecting financial institutions. Not only has the subcommittee examined the affects in her home state of West Virginia, but also in Wisconsin, Illinois, Georgia and Texas. Additionally, state chief financial officers are starting to examine the affects of regulations on state-chartered institutions.

There can be no doubt that small banks and credit unions have gone out of business. The fewer the number of local banks and credit unions in a community, the fewer the small businesses’ financing choices. Fewer choices drives up prices. Economists are starting to provide the proof to support these claims. In a study published in the August issue of the Journal of Financial Economics, co-authors Ramana Nanda of Harvard Business School and Rodrigo Canales of the Yale School of Management, found that local banks may not be the best option for financing small businesses, if the local banks face no local competition. The lack of choices for small business lending allows small lenders to cherry-pick their customers and charge higher interest rates.

It’s easy to be a picky lender when you are the only game in town. Thus, in order for the small business that are the backbone of the American economy to survive, the small lenders need to survive. If not, we may all be facing a run on mattresses.

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