The Clearing House

August 15, 2011

Via electronic delivery

Nondepository Supervision
Consumer Financial Protection Bureau
1801 L Street NW
Room 513-H
Washington, D.C. 20036

RE: CFPB Docket No. CFPB-HQ-2011-2

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House")[1] appreciates the opportunity to provide comment to the Bureau of Consumer Financial Protection ("CFPB") in response to its Notice and Request for Comment ("Notice")[2] regarding Defining Larger Participants in Certain Consumer Financial Products and Services Markets under Section 1024 ("Section 1024") of the Consumer Financial Protection Act of 2010 ("Act").[3] Section 1024 establishes the framework for supervision of nondepository covered persons (each, a "Nondepository") under the Act.

The financial crisis that led to the passage of the Act demonstrated the impact of a disruption in retail financial services markets, in this case the residential mortgage market, on the broader economy. The financial crisis also demonstrated that problems originating at Nondepositories can lead to adverse consequences for consumers.[4] These events demonstrated the importance of supervision of Nondepository providers of financial products and services, particularly Nondepository providers of products and services historically provided by banks and other depository institutions. In this regard, the Act established as the

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[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Association is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs, and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the funds transfer, automated clearinghouse, and check image payments made in the United States. For additional information, see The Clearing House's Web page at www.theclearinghouse.org.

[2] 76 Fed. Reg. 38059 (June 29, 2011).

[3] Pub. L. No 111-203, § 1024, 124 Stat. 1376, 1987 (2010).

[4] *See, e.g.,* FINANCIAL CRISIS INQUIRY COMMISSION, FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSE OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES (January 2011), at 157-164 (identifying unregulated mortgage lenders' "brazen obsession with increasing loan originations, without due regard to the risks associated with that business strategy," as well as the inadequacies of data regarding fraud among lenders that were not federally regulated), *available at* http://www.gpoaccess.gov/fcic/fcic.pdf.

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purpose of the CFPB to "enforce Federal consumer financial law consistently for the purpose of ensuring . . . that markets for consumer financial products and services are fair, transparent, and competitive."[5] The Clearing House supports this purpose and the CFPB's efforts to define the scope of its supervisory authority under Section 1024.

In pursuit of this purpose, The Clearing House believes that effective consumer protection in the area of financial services—particularly in the areas of core banking functions, such as deposit, payment, and lending-type functions[6]—starts with a supervisory regime that emphasizes Federal and state consumer financial protection law compliance issues; however, The Clearing House strongly believes that supervision must go beyond compliance. As discussed more fully below, years of bank supervisory experience confirm that the effective delivery of financial services is promoted by (i) supervision of compliance with applicable laws; (ii) adherence to robust standards for financial responsibility; and (iii) the management of the credit, market, liquidity, operational, legal, and reputational risks. The failure of any of these three can jeopardize the ability of a financial services provider to deliver the products or services that the provider has undertaken to deliver and can lead to practices, such as inadequate loan underwriting standards, that can cause serious harm to consumers.[7]

BACKGROUND

Section 1024 applies to Nondepositories that provide mortgage-related services, student loans, payday loans, and "larger participant[s] of a market for other consumer financial products or services, as defined by [the CFPB]."[8] The CFPB is required to issue an initial rule implementing Section 1024, after consultation with the Federal Trade Commission, not later than July 21, 2012.[9] Under Section 1024, the CFPB must require reports from, and conduct examinations of, Nondepositories for purposes of assessing compliance with Federal consumer financial law, obtaining information about activities and compliance systems or procedures, and detecting and assessing risks to consumers and markets for consumer financial products or

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[5] *Id.* § 1021(a).

[6] Based on case law, the Board of Governors of the Federal Reserve System has historically used a cluster of products to define banking for competitive purposes. This cluster, includes various kinds of credit and services such as checking accounts and trust administration. *See, e.g., United States v. Philadelphia National Bank*, 374 U.S. 321, 357 (1963). Nondepositories often provide lending and payment services that compete with the payment services that banks provide as a part of deposit account services.

[7] The Clearing House recognizes that the supervisory regime described in this letter will require significant resources and some time to implement fully. The Clearing House believes that, for this very purpose, the CFPB has been provided with significant financial resources under the Act. Moreover, The Clearing House understands that most Nondepositories will be subject to the jurisdiction of state enforcement officials, both under state law and under Section 1042 of the Act. The Clearing House notes that the potential for state enforcement actions underscores the importance of a well-documented supervisory program issued by the CFPB, to ensure consistent enforcement by state and Federal officials and, therefore, more efficient and competitive markets.

[8] *Id.* § 1024(a)(1)(B).

[9] *Id.* § 1024(a)(2).

services. Reporting requirements and examination procedures are required to be risk based.[10] The CFPB is required to focus on risks to consumers and to consider the asset size of the covered person, the volume of consumer transactions in which the covered person engages, the risks to consumers from the provision of consumer financial products and services, the extent to which covered persons are subject to oversight by state authorities, and other relevant considerations.

The CFPB also has the power to prescribe rules to facilitate supervision of Nondepositories, including record keeping requirements and requirements to ensure that such persons are legitimate entities and are able to perform their obligations to consumers. These latter requirements can include "appropriate financial requirements," and may, for example, include capital requirements.[11] In addition to these powers under Section 1024, under Section 1022 of the Act, the CFPB has the power to require registration of all covered persons, including Nondepositories.

The Notice requests comment on all issues relevant to defining "larger participants" subject to Section 1024. In addition, the Notice requests comment on three general issues relating to the larger participant rule: (i) criteria and thresholds to define a larger participant, (ii) data to be used in measuring criteria and measurement dates, and (iii) supervision time frames. The Notice also requests comment on other consumer financial product and service markets that should be included within the scope of the initial rule. The Notice discusses six specific markets: debt collection; consumer reporting; consumer credit and related activities; money transmitting, check cashing, and related activities; prepaid cards; and debt relief services. Note that within consumer credit and related activities, mortgage credit, student loans, and payday loans are already expressly covered by Section 1024, and not subject to the larger participant limitation.

SUMMARY

The Clearing House strongly believes that that the CFPB should

1. define both "larger participants" and "markets" under Section 1024 broadly, based on the risks that such participants and markets pose to consumers;
2. use bank reporting and examination requirements, including Federal Financial Institutions Examination Council ("FFIEC") and other Federal banking agency guidance on operations and risks, as a model for reporting by, and examination of, Nondepositories that provide core banking services, including payments and lending services; and
3. use bank capital requirements as a model for "appropriate financial requirements" to ensure that Nondepositories that provide core banking services, including

[10] *Id.* § 1024(b).

[11] *Id.* § 1024(b)(7)(C).

account, payment, and lending services, are able to meet their obligations to consumers.

DISCUSSION

1. *Consistent with the purposes of the CFPB, the initial rule should broadly define "larger participants" and "markets," based on the risks that such participants and markets pose to consumers.*

Larger Participants

As an initial matter, it is important to recognize that, while regulation can define the obligations of Nondepositories to consumers, supervision is necessary to ensure that those obligations are performed. The requirements of Federal consumer financial law are complex and technical. Examination for compliance with these requirements is the most effective way to ensure that these requirements are being met. Bank providers of consumer financial products and services have been subject to rigorous examinations over the years, while Nondepositories have been subject to "hit-or-miss" oversight triggered by only the most visible and most egregious violations of consumer financial laws. As discussed below, this disparity between the supervision of banks and Nondepositories has contributed to markets for consumer financial products that are both unfair and opaque to consumers and anticompetitive among providers.

In addition, the protection of consumers in transactions involving consumer financial products or services also requires that providers of such products and services be financially responsible and capable of meeting their obligations in a timely manner. For example, in the case of payment services, the payment service provider must be able to discharge its obligation to deliver the consumer's money in accordance with the applicable payment instructions, whether the payment takes the form of a money transmission or a prepaid card. The temptation to invest customer funds awaiting settlement in high-yielding but risky investments must be avoided, and the service provider must have adequate systems and controls to ensure that payments are completed in a timely and proper manner. These types of issues can only be adequately policed through hands-on supervision, based on appropriate reporting requirements, regular examinations, and measures to ensure financial responsibility, discussed further below.

It is within this context that we address the concept of a "larger participant," for purposes of Section 1024. The Clearing House strongly believes that the initial rule should broadly define larger participants, because a consumer that incurs a loss or other harm in connection with a consumer financial product or service will be harmed at least as much if the harm is caused by a smaller market participant, as compared to a larger participant. That is, the smaller market participant may have fewer financial or operational resources to ensure that it can fulfill its obligations to the consumer or respond when it fails. For example, a consumer making a payment though a money transmitter risks losing her funds or having the payment delayed for operational reasons. These problems are every bit as likely to occur, if not more likely to occur, at a small money transmitter as at a large money transmitter. Indeed, economies of scale at a large money transmitter may enable it to develop more sophisticated

systems that are less vulnerable to technical problems that could cause delays. Similarly, a borrower from a smaller lender is every bit as likely to receive inadequate disclosures as a borrower from a larger lender. Again, the resources of the larger lender may enable it to navigate the maze of federal disclosure, and other, requirements more effectively. For this simple reason, The Clearing House believes that the CFPB should define "larger participant" as broadly as possible within the statutory constraint.

In addition, as stated in Section 1021 and described above, the purpose of the CFPB is to "ensure[] that all consumers have access to financial markets for consumer financial products and services and that markets for consumer financial products and services are fair, transparent, and competitive."[12] Supervising only some participants in a market while failing to supervise others will be *unfair* to consumers because it will lead to consumer confusion and harm; *opaque*, rather than transparent, because consumers will not understand differing levels of supervision; and *anticompetitive* because smaller participants will be able to avoid the costs attendant on supervision. Such an approach would be entirely inconsistent with the purpose of the CFPB.

Recognizing the importance of coverage under Section 1024 to the protection of consumers, it would be unfair to consumers to leave any *material* providers in a market for consumer financial products and services outside of the coverage of Section 1024. Consumers are unlikely to be aware of which providers are covered by Section 1024 and which are not covered. Even if they are made aware of coverage, it is unlikely that consumers will understand the significance of coverage or the risks of dealing with a provider that is not covered. Contrary to the purpose of the CFPB, this situation is simply unfair to consumers. Similarly, a market with differing levels of supervision where the application and significance of those differing levels of supervision is not readily understood by consumers can hardly be viewed as transparent—again, contrary to the purpose of the CFPB. Finally, a market with different levels of supervision cannot be considered to be a competitive market. Making reports, cooperating with examiners, and maintaining appropriate financial arrangements are all costly to the supervised entities. When these costs are only imposed on some entities and not on others, such costs distort the market in favor of unsupervised entities that avoid such costs. Comparatively lower costs may lead to comparatively lower prices for the products and services offered by unsupervised providers, encouraging consumers to use the lower cost product or service, but consumers unknowingly absorb the increased risk.

For these reasons, The Clearing House believes that the CFPB should define "larger participant" broadly to avoid harm to consumers and an unlevel playing field in these markets. Any Nondepository engaged to any material degree in the business of consumer financial products or services should be considered a "larger participant" subject to supervision under Section 1024 and, consistent with its statutory purposes, the CFPB should cast a wide net in determining which larger participants should be subject to risk-based supervision. To the extent that the CFPB must place a "floor" on the definition of "larger participant," The Clearing House believes that the floor should be based on the number of consumers affected by the

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[12] *Id.* § 1021(a).

participant on an annual basis and the potential effects of problems with those financial products or services on the consumers involved. If the CFPB seeks to establish specific thresholds, which would have the advantage of providing certainty, such thresholds could vary from market to market, unless the threshold is set at a *de minimis* level. For example, the CFPB could establish thresholds under which any covered person providing more than one thousand transactions a year or holding more than one thousand consumer accounts would be subject to supervision under Section 1024.

Finally, with respect to dates and time frames, The Clearing House believes that the CFPB should determine what "larger participants" are subject to supervision under Section 1024 and begin the work of safeguarding consumers as soon as possible. The Clearing House commends the CFPB for issuing the Notice one full year in advance of the statutory deadline. As consumers increasingly look to Nondepository providers of consumer financial products and services, consumers' exposure to such unsupervised providers grows. Accordingly, The Clearing House urges the CFPB to implement its authority under Section 1024 expeditiously. As described above, much of the framework required to supervise Nondepositories has already been developed and refined over the years by Federal bank supervisors.

Markets

The Clearing House supports the CFPB's identification of the debt collection, consumer reporting, consumer credit and related activities, money transmitting, check cashing and related activities, prepaid cards, and debt relief service markets described in the Notice. These markets, along with the statutorily prescribed residential home mortgage, student loan, and payday loan markets, should be defined broadly so as to reduce the potential for consumers to engage in unsupervised transactions under the mistaken assumption that the transactions are supervised.

The Clearing House believes that Nondepositories that perform other core banking deposit, payment or lending-type functions such as holding funds for customers, or providing payment services, which are not in the form of money transmitting, check cashing or prepaid cards, should also be subject to supervision under Section 1024. For example, emerging mobile payments markets, in which payments are billed to an account at a Nondepository, and providers of virtual currencies should also be identified for supervision under Section 1024. Even though some Nondepositories that provide payment or payment related services are currently regulated at the Federal level for purposes of Bank Secrecy Act and Anti-Money Laundering compliance, they are not currently supervised at the Federal level for consumer protection purposes.

2. *Bank reporting and examination requirements should serve as a model for reporting by, and examination of, Nondepositories that provide core banking services.*

The Clearing House believes that the definition of "larger participants" under Section 1024 cannot be divorced from consideration of the content of the supervisory regime under Section 1024. As described above, consumers are exposed to higher risk financial products and services provided by Nondepositories under the existing, weak supervisory regime. The Clearing House believes that the Federal bank supervisory model with its extensive reporting

requirements, guidance, and examination, has been shown to be the most comprehensive model when addressing the risks inherent in financial services more broadly. Therefore, the Federal bank supervisory model should form the basis for the CFPB's exercise of its reporting, examination, and other powers under Section 1024. The closer that Nondepository reporting and examination requirements parallel the requirements applicable to insured depository institutions, the more consistent the consumer protections will be across providers of consumer financial products and services.

The Federal banking agencies have identified a series of risks in providing financial services that are related to, but go beyond, strict compliance with laws. The Clearing House considers the management of such risks integral to ensuring that Nondepositories are able to meet their obligation to consumers.[13] To address these risks, the Federal banking agencies have issued extensive guidance on managing and controlling risks. For example, the FFIEC has issued a series of "Booklets" providing guidance on specific issues. In the area of retail payments, for example, such guidance includes Booklets on Audit, Business Continuity Planning, Development and Acquisition, E-Banking, Information Security, Management, Operations, Outsourcing Technology Services, Retail Payment Systems, and Supervision of Technology Service Providers. In these Booklets alone, there are more than 600 pages of guidance with which depository institutions providing retail payment services are expected to comply.

In order to ensure that Nondepositories are able to meet their obligations to consumers as contemplated under Section 1024, Nondepositories should be examined under standards similar to the bank guidance cited above. For example, a money transmitter needs to have reliable and secure systems in order to provide timely payments for its customers and to safeguard information about its customers. If the money transmitter provides services on-line it must have effective and reliable authentication procedures to avoid unauthorized transactions. These are the types of issues that are addressed by the FFIEC guidance. It is also necessary to apply similar standards to Nondepositories in order to carry out the purposes of the CFPB to provide for transparent and competitive markets. As noted above, markets subject to differing supervisory standards are neither transparent nor competitive. Of course, the guidance that is applicable to the specific consumer financial products and services provided by

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[13] Such risks are defined in the Federal Reserve's Commercial Bank Examination Manual ("Manual") and include credit, market, liquidity, operational, legal, and reputational risks. The Manual describes these risks as follows: *credit risk* arises from the potential that a borrower or counterparty will fail to perform on an obligation; *market risk* is the risk to a financial institution's condition resulting from adverse movements in market rates or prices, such as interest rates, foreign-exchange rates, or equity prices; *liquidity risk* is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding (referred to as "funding liquidity risk"), or the potential that the institution cannot easily unwind or offset specific exposures without significantly lowering market prices because of inadequate market depth or market disruptions (referred to as "market liquidity risk"); *operational risk* arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud, or unforeseen catastrophes will result in unexpected losses; *legal risk* arises from the potential that unenforceable contracts, lawsuits, or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization; and *reputational risk* is the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions.

Nondepositories will vary, and the CFPB should tailor its implementation of Section 1024 accordingly.

3. *Nondepositories should be subject to financial requirements that parallel bank capital requirements to ensure that Nondepositories that provide core banking services are able to meet their obligations to consumers.*

The Clearing House believes that, in order to protect consumers, it is critical that the CFPB implement its Section 1024 authority to "require appropriate financial requirements" to ensure that Nondepositories are able to meet their obligations to consumers.[14] The protection of consumers in the provision of almost all financial services requires that the service provider is able to meet some obligation in the future. The most obvious example of this requirement is in the depository context, where a consumer holds funds in a deposit account at a depository institution and draws on that account at a future date in accordance with the terms of the deposit agreement. The ability to meet obligations in the future is equally as critical for Nondepositories. For example, in payment services, a payment service provider receives funds from the consumer for payment to a third party, and the service provider must be able to execute the payment instruction at some future point in time. The ability to meet obligations in the future is present in other financial services, as well, if only to be able to sustain operations or to resolve errors adversely affecting consumers. For example, an effective consumer protection regime requires that a consumer lender be able to refund excess charges or to satisfy liability under the Electronic Fund Transfer Act or other Federal consumer laws.

Depository institution supervisors have long relied on capital requirements, under which specified leverage and risk-based ratios must be met for institutions engaged in transactions with third parties as principal. Moreover, capital requirements are not unique to banks: trust companies, which provide purely custodial services that do not involve credit, market, or liquidity risks, are subject to capital requirements to ensure that they can absorb losses in current operations and continue to meet their obligations to customers.[15] We note that, although some states' supervisory regimes for Nondepositories rely on bonding or the segregation of assets, almost all financial assets, other than insured transaction amounts at depository institutions, carry a level of credit, market, or liquidity risk, and even the segregation of consumer funds into essentially riskless short-term Federal government obligations does not address the risk to the performance of future obligations from operating losses. For example, a money transmitter holds customer funds pending completion of the customer's payment. Although the money transmitter may invest those funds in permitted investments under state law, to the extent that the money transmitter uses term investments, instead of a transaction account at a bank with pass-through deposit insurance, in order to receive a higher yield, these investments will be subject to market risk that can threaten the money transmitter's ability to

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[14] The inclusion of this authority in Section 1024 and not in Section 1025 and 1026 on supervision of banks is significant and supports The Clearing House's view that the CFPB should be using the bank model for ensuring that Nondepositories are able to meet their obligations to consumers.

[15] *See, e.g.,* Comptroller's Licensing Manual, Fiduciary Powers, June 2002.

satisfy its payment obligations. Capital requirements are the most effective way to address these risks.

Depository institution capital requirements have undergone decades of evolution through a series of financial crises that have shaped both the levels of capital required for different activities and the form or instruments that can be used to satisfy those capital requirements. The Clearing House believes that the CFPB should draw from depository institution capital requirements as a starting point for ensuring financial responsibility in Nondepositories subject to Section 1024. Other tools to ensure that Nondepositories are able to meet their financial obligations to consumers (e.g., background checks and bonding) are also utilized in the supervision and regulation of depository institutions; *however*, they are not a substitute for appropriate capital requirements.

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Thank you for your consideration and review of our comments. If you have any questions or wish to discuss The Clearing House's comments, please feel free to contact me at (336) 769-5314.

Yours very truly,

Robert C. Hunter
Deputy General Counsel