Existential challenge

The US Court of Appeals for the Fifth Circuit last month ruled that the CFPB is unconstitutionally funded. **Simon Boughey** investigates what this landmark judgment means for the securitisation industry.

Those in the securitisation industry concerned by the implications of the lawsuit brought by the Consumer Financial Protection Bureau (CFPB) against National Collegiate Master Student Loans Trusts *(SCI 12 April 2021)* **will have been encouraged by the 19 October ruling that the CFPB is unconstitutionally funded. The significance of this judgment for the CFPB, made by the US Court of Appeals for the Fifth Circuit, cannot be underestimated.**

It means that some defendants in past actions taken by the CFPB are likely to claim such suits are invalid, as the Bureau was unconstitutionally structured. It also means the Bureau is perhaps less likely to pursue new cases, as these are likely to be challenged on the same grounds, say lawyers.

The appeals court gave its verdict in the case of 'Community Financial Services Association of America, et al. versus CFPB, et al.', in which the plaintiffs challenged the CFPB's 2017 Payday Lending Rule on a number of counts. One of these was that the funding structure of the CFPB violates the Appropriations Clause of the US Constitution, and it was this point with which the court agreed.

But the ramifications of the decision spread far beyond payday lending, as it rests on the fundamental financial underpinning of the CFPB and consequently amounts to "an existential challenge to the agency and to all of its actions," according to law firm Hunton Andrews Kurth in a note on the topic.

"The court has said that the CFPB was relying on funding that was unconstitutional to roll out the payday lending rule and therefore it's unwinding that rule. This is the biggest ripple effect. Everything that they have now done could be subject to challenge based upon the funding issue," says Eric Hail, a partner at Hunton AK in Dallas, Texas.

Unlike the great majority of executive agencies, the CFPB does not rely on annual appropriations for its funding, as agreed by Congress. The Fifth Circuit determined that the Appropriations Clause ensures exclusive Congressional power over the Federal purse and is vital to the separation of powers.

In its defence, the CFPB claims that it is not in any way special. "There is nothing novel or unusual about Congress's decision to fund the CFPB outside of annual spending bills. Other federal financial regulators and the entire Federal Reserve System are funded that way and programmes such as Medicare and Social Security are funded outside of the annual appropriations process," a spokesperson for the Bureau told SCI.

This argument has some validity. The Federal Reserve, the Commodity Futures Trading Commission (CFTC), the Office of the Comptroller of the Currency (OCC) and the Federal Housing ▶

Finance Authority (FHFA) also bypass the appropriations process.

But, says the Fifth Circuit, the CFPB has what amounts to a "double insulation" from normal process, in that it not only receives money directly from the Fed but also the director of the Bureau stipulates exactly how much it needs. The Fed is obliged to pay this as long as it doesn't exceed 12% of total operating expenses (US$6.47bn in 2020). This is unique, and this is what is unconstitutional, says the Fifth Circuit.

The CFPB is almost certain to contest this ruling, which is then likely to make it way all the way up to the Supreme Court unless Congress steps in. Given the current disposition of the Supreme Court, and its so-called 'originalist' stance on a number of topics, it seems quite likely that it will side with the Fifth Circuit.

"If I had to bet one way or another, I think the Supreme Court will agree with the Fifth Circuit. They did agree with the Fifth Circuit on the FHFA director being subject to presidential dismissal, for example," says Chris DiAngelo, a partner with Katten Muchin Rosenman in New York.

If indeed it does agree, Congress would have to step in and a new funding structure arranged. But at the very least, this throws a spanner into the works of the CFPB. Past actions will now be subject to appeal on the grounds that they were made by a body unconstitutionally founded, and future actions may well be curtailed.

"I think they are bruised. The Bureau may well be more hesitant to take certain actions, given the potential challenges. Put another way, it has given ammunition to people that are unhappy with an action taken by the CFPB," says Hail.

This is welcome news to interested parties in the securitisation industry that had been perturbed by the 2017 case against student loan trusts, and the subsequent refusal to have this case dismissed by the Third Circuit Court of Appeals in December 2021.

The CFPB sought to define these student loan trusts as 'covered persons' under the terms of the Consumer Financial Protection Act (CFPA) and make them thus liable for abusive practices carried out by debt servicers. Of course, trusts are merely shell vehicles, and any financial penalties incurred by the trusts would have to be borne by investors.

By agreeing with this definition, the Court opened up a large can of worms for the structured finance business in the US. As Cadwalader, Wickersham and Taft said at the time: "The Court's ruling thus creates a new line of potential exposure for entities, like securitisation trusts and other whole loan buyers, that acquire consumer loans on a servicing retained basis or enter into a servicing agreement with a third-party servicer acting as an independent contractor."

In February 2022, Fitch also noted: "The recent ruling that 15 national collegiate student loan trust issuers are subject to the enforcement authority of the CFPB could result in increased risk of unforeseen monetary losses for these NCSLT issuers and also could result in monetary losses in the future for other US structured finance transactions backed by consumer assets, where similar misconduct is found to have occurred."

In view of the widespread concern in the market caused by the covered persons argument, the verdict of the Fifth Circuit on 19 October is certain to have aroused relief. The CFPB, however, denies that its wings have been clipped.

"The CFPB will continue to carry out its vital work enforcing the laws of the nation and protecting American consumers," a spokesperson told SCI.

However, even before the 19 October verdict, there was no guarantee that actions undertaken by the CFPB would not run into the unswerving, and final, opposition of the Supreme Court. While federal agencies might be awash with a new mission and sense of purpose to right wrong wherever they see it, the Supreme Court has a very different view of the limitations of agency powers.

Of the nine current justices, three were appointed by President Trump, two by President George W Bush and one by President Bush. These six have what has been described as an "originalist" view of the separation of powers and believe in making sure that agencies are accountable to Congress and thus the electorate.

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The confirmation of Rohit Chopra as the director of the CFPB in September 2021 caused alarm bells to be rung along Wall Street. On the progressive wing of the Democratic party, he has, for example, advocated closer scrutiny of financial institutions and called for the cancellation of student debt.

At the SFA Conference in Las Vegas in October last year, less than a month later, Rachel Rodman, a partner at Cadwalader, Wickersham and Taft, warned that with his appointment the securitisation industry should be prepared for "more frequent enforcements and bigger fines."

She added that there would be "new and novel interpretations of what constitutes a covered person."

The inauguration of Chopra at the head of an Obama-era agency, erected after the credit crisis of 2008/2009, seemed to be symbolic of a very new spirit on Washington, DC from an administration committed to intervention in many areas of the US economy to secure policy aims.

While many of the CFPB initiatives could be seen to be well-intentioned, there was a general fear that the law of unintended consequences would apply and that an area of the financial industry of acknowledged benefit to the American consumer would be damaged, perhaps fatally.

Some of the long-term effects of CFPB action might not always be unintended either. "With the Bureau, it's always a case of, 'Oh that sounds like a good idea'. And then when you get into it, you realise that there's an angle," says another lawyer.

This view was announced very clearly in the June ruling on West Virginia versus the Environmental Protection Agency (EPA), in which the Court determined the EPA does not have the power to set emission targets for power plants, as this should be a question for individual states to decide.

In doing so, the Court side-stepped the landmark Chevron versus Natural Resources case of 1984, which essentially held that if a statute is not very clear, then a federal agency is free to interpret it as it sees fit. It has been seen as the salient case in this area of administrative law for almost 40 years, but has received no citations in the recent judgments.

"As Chevron gets shunted aside, older concepts of statutory interpretation and regulatory power have come back. There is a change of expectations," says DiAngelo.

So, while many of the federal agencies are packed with Biden appointees and determined to do battle with Wall Street and corporate America – perhaps, in the process, damaging markets on which many consumers knowingly and unknowingly depend – they will run into an implacable foe in a Supreme Court determined to bring unfettered activist bureaucrats to heel.

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