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Concerning

"Guilty until Proven Innocent?

A Study of the Propriety & Legal Authority for the Justice Department's Operation Choke Point"

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Chairman Bachus, Ranking Member Johnson, and Members of the Subcommittee. Good morning, and thank you for inviting me to participate in today's hearing on "Guilty until Proven Innocent? A Study of the Propriety & Legal Authority for the Justice Department's Operation Choke Point." I am honored to be included among the distinguished members of this panel, and I am pleased to be able to share with you today my thoughts on the deeply-troubling legal issues that are raised by the Department of Justice's ("DOJ") Operation Choke Point.

DOJ is now using against legitimate American businesses tactics that are strikingly similar to those that have been used against corrupt foreign institutions serving terrorists. Working with DOJ, the Federal Deposit Insurance Corporation ("FDIC"), the Office of the Comptroller of the Currency ("OCC"), and the Board of Governors of the Federal Reserve System ("the Board") have conspired to choke off and strangle legitimate businesses by depriving them of their access to the financial system. Many of the victims of Operation Choke Point are law-abiding companies, ranging from coin dealers to dating services. With their ability to open a bank account or even to deposit a check now taken from them, these law-abiding companies are being deprived of their right to pursue their chosen trade and of their very right to exist.

DOJ has undertaken this operation without any Congressional authorization. Although they may disapprove of these businesses, neither FDIC, nor OCC, nor the Board has the power to shut the industry down, or even significantly restrict it, through ordinary, legal means. The statutes under which these three agencies perform their regulatory duties authorize them to ensure the safety and soundness of the banks. While these agencies have the authority to police the banking system, they have no authority to judge and condemn whole industries as unworthy of access to that banking system. It is neither surprising nor unreasonable that Congress has not delegated such sweeping power.

To make matters worse, DOJ and the banking agencies have failed to provide these law-abiding companies, including short-term credit providers, with any opportunity to be heard and to defend themselves against these scurrilous accusations and slanders. The agencies have chosen to proceed not through notice and comment rulemaking nor through any procedure that would expose their operation to the oversight of the Congress; they have acted instead through a back room campaign of veiled threats and regulatory intimidation. They have made no effort to distinguish those who are breaking the law from those who are making every effort to comply with not only the letter but also the spirit of our consumer protection laws. In sum, Operation Choke Point is unconstitutional, unlawful, and simply un-American.

I. The Short-Term Credit Industry Meets the Needs of America's Underserved Communities.

I come before you today to speak on behalf of the Community Financial Services Association of America (CFSA), the leading trade association representing short-term credit providers. The Association and its members provide short term loans that help consumers, many of whom are underserved, make ends meet in today's difficult economic conditions. These loans are typically the equivalent of an advance on the borrower's paycheck or other source of regular income. They provide a type of short-term credit to over nineteen million American households, helping to bridge the unexpected financial needs that often arise between income installments.

A short-term, small dollar loan is a convenient and reasonably-priced vehicle for short-term financial needs, often cheaper than overdraft fees and late fees on credit cards or utility bills. Many short-term credit providers offer other financial services to their customers, including bill payment, check cashing, installment loans, and prepaid debit cards. Like short-term small dollar loans, these lines of business serve critical needs in underserved communities. Members of these communities often cannot obtain any service from a bank or can obtain those services only at costs far higher than would be charged by a short-term credit provider. Furthermore, customers want these products, as they believe they are cost competitive and effective and are satisfied with their experiences with short term credit providers. According to a Harris poll of CFSA members' customers conducted in 2013, well over 90 percent expressed satisfaction with the terms (96%) and cost (92%) of their short-term small-dollar loans, had found that those loans provided a valuable safety net during times of unexpected financial difficulty (95%), and believed that they should be free to take out such a loan without government interference (95%).

Both the Congress and the State legislatures have recognized the importance of short-term small-dollar loans and the potential consequences of their misuse. As a result, most States—oftentimes acting in consultation with and with the cooperation of the trade associations that represent the short-term credit industry—have passed robust consumer protection laws to ensure that loans are offered and consumed responsibly. These laws require licensing to specifically authorize these lenders to operate in their state, may cap the amount of the loan or its fees, limit the number of times a consumer may renew a loan, and/or require certain disclosures. Every member of the CFSA must hold a license and comply with the laws in every state in which they maintain a storefront location and in every state in which their online customers reside. The federal consumer financial protection laws also apply to these lenders, including TILA, ECOA, EFTA, FCRA, and UDAAP. Notably, the Truth in Lending Act, 15 U.S.C. § 1601 et seq., requires full disclosure of the costs and terms of the loans in order to ensure that consumers have the information they need to make responsible borrowing decisions. Short-term credit providers are frequently examined by state regulators and by the CFPB.

Short-term credit providers of necessity rely on banking services to operate. When a prospective borrower applies for the loan—at a storefront location, or online—he or she typically provides a post-dated check or an electronic debit authorization for the value of the loan, plus a fee. The lender immediately advances the customer funds, then after a specified period of time, usually determined by the customer's next payday, the borrower returns to repay the loan and fee. But if the customer does not return, the terms of the transaction permit the lender to deposit the post-dated check or to execute the debit authorization. In order to have that security, the lender must have a deposit account with a bank and/or access to the Automated Clearing House (ACH) network.

It is their reliance on the banks for conducting their businesses that made short-term credit providers an easy first target for DOJ's campaign against lawful businesses who are disfavored by the current administration. Lacking the legal authority to regulate short-term credit providers, FDIC, OCC, and the Board have, in coordination with DOJ, conducted a campaign of extra-legal regulation, first imposing an expanded standard of reputation risk on the industry and then using that standard to threaten banks who do business with short-term credit providers. It is about the legal and, specifically constitutional, concerns that are raised by this campaign of de facto regulation and administrative intimidation that I would like to speak with you today.

II. The Ever-Expanding Regulatory Definition of "Reputation Risk."

The agencies have the authority under the Federal Deposit Insurance Act to ensure the safety and soundness of the banking industry. See 12 U.S.C. § 1831p-1. In performing their statutory duty, the agencies have required that the banks have adequate procedures in place to assess and manage risk.[1] Among the specific risks that a bank must manage is the risk that its reputation may become tarnished in the eyes of the public.

The agencies had previously and consistently defined the concept of "reputation risk" to refer specifically to those risks to a bank's reputation that arose from the products and services provided by the bank itself and by third parties with whom a bank contracted for the provision of those products and services. A bank's reputation could suffer, in other words, if it provided or seemed to provide poor products and poor service to its customers.

The agencies had never before held that a bank needed to assess the reputation of its customers as part of its management of reputation risk. Banks insured their good reputation by meeting the needs of their customers, not by judging the popularity of their customers.

This is, of course, not to say that a bank had no need to evaluate its customers. A bank is required to have procedures in place that ensure that it does not engage in illegal activity or facilitate the commission of crimes by its customers; this risk is encompassed under the rubric of compliance risk, however, not that of reputation risk. A bank was never before required to have procedures in place to ensure that it did not have customers who, though lawfully engaged in

[1] The agencies have identified several such risks that a depository institution must manage. These include credit risk, market risk, liquidity risk, operational risk, and compliance risk. See, e.g., FRB, Supervisory Letter: Risk-focused Safety and Soundness Examinations and Inspections. SR 96-14 (May 24, 1996).

demonstrably lawful business pursuits, might simply be unpopular with the public or with the current administration.

Although DOJ is now using FDIC, OCC, and the Board to wage its covert campaign against disfavored industries and businesses, these three agencies had already for some time been expanding their regulatory power through a gradual process of interpretive redefinition of the concept of reputation risk. They carried out this process of incremental self-aggrandizement by progressively unmooring the concept of reputation risk from its traditional definition within the banking industry.

For example, in the summer of 2011, FDIC published a Supervisory Insight article entitled "Managing Risks in Third-Party Payment Processor Relationships." The article warns banks of heightened risks, including reputation risks, associated with doing business with certain types of merchants, including online payday lenders. FDIC, Managing Risks in Third-Party Payment Processor Relationships, SUPERVSIORY INSIGHTS, Summer 2011, at 3. For the first time, the article offers a list of 30 merchant categories, including online payday lending and numerous other lawful businesses that the agency has deemed to involve "high-risk" activity. The Department of Justice has acknowledged, in response to legislative investigations of Operation Choke Point, that FDIC developed this list of "high-risk merchants" for purposes related to regulating the banking industry. Letter from Peter J. Kadzik, Assistant Attorney General, U.S. Department of Justice, Office of Legislative Affairs, to the Honorable Tim Johnson, Chairman, Committee on Banking, Housing, and Urban Affairs, U.S. Senate, 4 (June 24, 2014). The article further urges banks to be wary of customers with high aggregate return rates and those that bank with more than one financial institution. *Id.*

In imposing this new interpretation of reputation risk upon the banking industry, the agencies have consistently chosen to proceed without providing the public with notice and an opportunity to comment. Furthermore, these agencies provide no objective criteria for measuring reputation risk or for distinguishing between law-abiding, responsible bank customers and bank customers that engage in fraudulent or otherwise unlawful financial practices. Far from tailored guidance that would aid banks in targeting those customers who are engaged in fraudulent or otherwise unlawful practices, the agencies have created a vague and subjective standard that can be used to pressure banks to cut off relations with law-abiding customers engaged in any line of business that is disfavored by DOJ.

The opportunity for abuse that is inherent in such a subjective and pliant standard is patent. Under the guise of protecting the safety and soundness of banks, FDIC, OCC, and the Board are now using this newly defined concept of reputation risk to wage a covert war against certain legitimate businesses that rely on banking services to function and that are disfavored by this administration, including short-term credit providers.

III. The Agencies Are Imposing Regulations on the Banking Industry Without Statutory Authority and Without Observing the Procedural Requirements of the Administrative Procedure Act.

In order to play their part in Operation Choke Point, the agencies are relying extensively on their redefinition of reputation risk, a concept now transformed into one that requires a bank to assess the reputations of each and every one of its customers and to refuse to do business with those customers whom, in the judgment of the regulators, the public might disfavor. The implementation of this new standard has been carried out without statutory authorization and without observing the procedures required by the Administrative Procedure Act.

The Administrative Procedure Act requires that agency actions be set aside when they are conducted "without observance of procedure required by law." 5 U.S.C. § 706(2)(D). Before it may promulgate a binding rule or substantially revise a previously announced interpretation, an agency must provide public notice in accordance with law and "give interested persons an opportunity to participate in the rule making through submission of written data, views, or arguments with or without opportunity for oral presentation." 5 U.S.C. § 553(b), (c).

The agencies failed to provide any sort of notice and opportunity to comment in advance of promulgating the rules relating to their new definition of reputational risk. These documents do more than merely announce "interpretative rules and statements of policy"; they have been and are being enforced by the banking agencies to create new legal obligations for banks wishing to do business with the entities described in guidance documents, including short-term credit providers.

Reputation risk—the fulcrum for Operation Choke Point—is no longer limited to the risk that negative publicity regarding a financial institution itself or third parties who provide services in its name will cause a decline in customer base, costly litigation, or loss of revenue. Reputation risk has now been redefined and remade into a concept that is vague, manipulable, and wholly foreign to customary bank examination practices.

As redefined, reputation risk could "ostensibly be invoked to compel a depository institution to sever a customer relationship with a small business operating in accordance with all applicable laws and regulations but whose industry is deemed 'reputationally risky' for no other reason than that it has been the subject of unflattering press coverage, or that certain Executive Branch agencies disapprove of its business model." Letter from Rep. Jeb Hensarling, Chairman, H. Comm. on Fin. Servs., to Janet Yellen, Chair, The Fed. Reserve Sys. (May 22, 2014). "The introduction of subjective criteria like ‘reputation risk’ into prudential bank supervision can all too easily become a pretext for the advancement of political objectives, which can potentially subvert both safety and soundness and the rule of law.” *Id*.

The requirements of the Administrative Procedure Act are not mere technicalities. Notice and comment rulemaking ensures that an agency will consider the ramifications of what it is doing, address the concerns of the regulated industry and of other interested parties impacted by the regulation, and adequately explain its statutory authority and its expert rationale.

Notice and comment rulemaking was devised by Congress in order to make sure that an agency does not adopt irrational, arbitrary, and capricious rules. The failure to make use of this statutorily-required procedure has here resulted in a rule that is vague, malleable, standardless, and open to misunderstanding, misapplication, and simple abuse. In promulgating their new definition of reputation risk, the Agencies’ have created precisely the sort of defective rule that notice and comment rulemaking was designed to prevent.

Of perhaps even greater concern, this novel definition of reputation risk has untethered the agencies from their statutory source of authority, making them no longer prudential regulators of American financial institutions, but the legal and reputational police of American society. As documents uncovered in recent investigations of Operation Choke Point confirm, short-term credit providers are only the first in a long series of businesses which the government now intends to target for extermination on the ground that they are “reputationally risky” in the eyes of the FDIC, OCC, the Board, and DOJ.

IV. The Agencies Have Deprived Americans of Their Liberty Without the Due Process of Law Required by the Fifth Amendment to the Constitution.

The Fifth Amendment to the Constitution guarantees that no person will be deprived of life, liberty, or property without due process of law. In their effort to advance their agenda, FDIC, OCC, and the Board have each violated this basic tenet of constitutional jurisprudence. Short-term credit providers have been the first industry to be stigmatized, branded, barred from pursuing their chosen line of business, and deprived of their banking relationships without any notice or opportunity to be heard and to defend their right to exist.

As an initial matter, the agencies have inflicted grave reputational harm upon CFSA's members and other law-abiding responsible short-term credit providers by stigmatizing them as "illegitimate," "fraudulent," and "high risk." They gave no notice to the industry of their judgment. They gave the industry no opportunity to be heard. They simply announced to the banks which they regulate that they had decided that short-term credit providers are "fraudulent." Under Operation Choke Point, sentence is now being passed and carried not only without due process of law but without regard for the guilt or innocence of the accused.

This stigma that the banking agencies have branded upon the law-abiding and responsible short-term credit providers now threatens to preclude them from pursuing their chosen line of business. Indeed, to choke off these businesses from the financial services that they must have in order to pursue their chosen line of business is the precise purpose of the agencies' actions, a purpose openly declared in the very name that the government has chosen for its unlawful enterprise: Operation Choke Point. America's short-term credit providers have been deprived of their right to continue to exist without having been provided any notice or having been afforded any opportunity to be heard.

Further, by attacking the reputations of short-term credit providers, the agencies have effectively coerced financial institutions to cease providing them with bank accounts and other essential financial services. The agencies have thus deprived these lenders of tangible benefits and interests that they had previously possessed. Again, they have done so without providing the process due under the law.

The behavior of these agencies and of DOJ in their conducting of Operation Choke Point has fallen well short of the requirements of the law of our land. Put simply, Operation Choke Point is patently, flagrantly, and intolerably un-American. This is not how law is made and enforced in America. This is not how justice is served in our society.

V. The Casualties of Operation Choke Point.

DOJ and the three banking agencies may claim that the aim of Operation Choke Point is to choke off only “fraudsters” and unlawful businesses, but the actual results of Operation Choke Point prove otherwise. The vague and malleable standard of reputation risk has provided banks with no guidance on how to discriminate between lawful and unlawful enterprises. Faced with the thinly-veiled threats of the banking regulators and the tactics of intimidation and prosecutorial bullying, the banks have had no choice but to yield to the coercion of their regulators and terminate those customers who failed to curry the favor of the administration. This concerted campaign has had the result, therefore, of sweeping away the members of the short-term credit industry without regard for guilt or innocence.

As a growing number of banks have terminated their relationships with law-abiding, licensed, and responsible short-term credit providers, these businesses must each day wonder when the government will terminate their remaining banking relationships and must compete for service within the ever shrinking pool of banks who remain committed to their mission of providing customer service and are willing to stand up to regulatory bullying.

I will offer a few examples of the damage that Operation Choke Point has already done to the short-term credit industry. One lender, Advance America, has lost longstanding and positive business relationships with at least nine banks as a result of Operation Choke Point. Hancock Bank and Whitney Bank informed Advance America of their intention to close its accounts on the ground that they were "unable to effectively manage [the lenders'] Account(s) on a level consistent with the heightened scrutiny required by [their] regulators . . . ." Fifth Third Bank wrote that it would stop doing business with short-term credit providers altogether on the ground that the entire industry is "outside of [its] risk tolerance." Synovus Bank and Umpqua Bank likewise terminated Advance America's accounts. At least two of Advance America's banks expressed regret and explained that the service terminations were the result of pressure from their prudential regulator. Cadence Bank also terminated Advance America's accounts without explanation. Advance America has not been able to find local banks to service certain stores that were affected by the terminations; many of the banks it contacted for that purpose had decided to exit the short-term small-dollar industry entirely due to regulatory pressure. No bank expressed a concern about Advance America; every bank based its determination on a sweeping judgment of the industry as a whole, an irrational judgment they were compelled to make by their regulator.

Another CFSA member, Cash Tyme, has received termination notices for its accounts at three financial institutions. Two alluded to the regulatory environment. Fifth Third Bank informed Cash Tyme, as it had informed Advance America that the entire industry was "outside [its] risk tolerance." Regions Bank informed Cash Tyme that it "ha[d] chosen to end relationships with certain types of customers deemed to be high risk." Cash Tyme has been unable to find substitute banks to service certain stores affected by the terminations, nor has it been able to find a bank that will provide ACH services.

CFSA Member Speedy Cash, Inc. (Lending Bear), after a seventeen year banking relationship, also received a termination notice from Bank of America. A bank officer told Speedy Cash, Inc. that Bank of America was "exiting the payday advance space," expressed regret at the decision, and led it to believe that the termination decision depended only on Speedy Cash Inc.'s classification as a short-term credit provider. Indeed, Speed Cash recently received a formal notice from Bank of America that its small business accounts would soon be closed "based on the nature of your business and associated risks." Furthermore, two of its current banking partners now refuse to open new accounts for Speedy Cash, Inc.

CFSA member Xpress Cash Management likewise received a termination notice from Fifth Third Bank that explained that the short-term small-dollar loan industry is "outside [its] risk tolerance."

The foregoing specific examples of banks that have terminated their relationships with CFSA members as a result of regulatory pressure are merely illustrative of the severely harmful effects of Operation Choke Point on the short-term credit industry. Numerous other CFSA members have lost longstanding, positive banking relationships, despite their law-abiding and responsible business practices.

The agencies and DOJ knew early on that their coordinated, coercive campaign of backroom pressure tactics was succeeding in prompting banks "to exit or severely curtail" business with all short-term credit providers, and that "banks may have therefore decided to stop doing business with legitimate lenders." Six-Month Status Report Mem. at 10.

Because short-term credit providers cannot survive without access to banking services, Operation Choke Point has begun to have its intended and necessary effect. As one internal DOJ memorandum noted, "a large Internet payday lender decided recently to exit the business due to difficulties securing a bank or payment processor relationship." Memorandum from Michael S. Blume, Dir., Consumer Prot. Branch of U.S. Dep't of Justice, to Stuart F. Delery, Principal Deputy Ass't Att'y Gen., Civil Div. of U.S. Dep't of Justice 2 (July 8, 2013), in COMM. REP. ON OPERATION CHOKE POINT app. at HOGR-3PPP000166. The regulators celebrated "this type of positive conduct." Six-Month Status Report Mem. at 6, 10.

Violating basic principles of due process should not be a cause for celebration. These agencies should put an end to the lawlessness engendered by Operation Choke Point and end the unfair targeting of lawful businesses and entire industries.