Consumer Finance Monitor (Season 7, Episode 21): Banks and Their Customer Relationships: What is the Appropriate Role of Bank Regulators?

Speakers: Alan Kaplinsky, Dru Stevenson, and Brian Knight

Alan Kaplinsky:

Welcome to the award-winning Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. This is a weekly podcast show brought to you by the Consumer Financial Services Group at the Ballard Spahr law firm, and I'm your host, Alan Kaplinsky, the former practice group leader for 25 years, and now senior counsel of the Consumer Financial Services Group at Ballard Spahr, and I'll be moderating today's program. For those of you who want more information, either about the topic we'll be discussing today or anything else in the world of consumer financial services, don't forget to consult our blog, which also goes by the name of Consumer Finance Monitor, same as our podcast show. We've hosted our blog since July 21, 2011 when the CFPB became operational, so there's a lot of relevant industry content there.

We also regularly host webinars on subjects of interest to those in the industry, so to subscribe to our blog or to get on the list for our webinars, please visit us at ballardspahr.com. If you like our podcast, please let us know about that. You can leave us a review on Apple Podcasts, Google, YouTube, or wherever you obtain your podcasts. Please also let us know if you have ideas for other topics that we should consider covering on our show or speakers that we should consider inviting as guests. I'm also very pleased to tell our listeners that our podcast show was within the last few months ranked by Good to Be Social as the number one podcast show among the law firm podcast show in the US devoted exclusively to the consumer financial services industry. Good to be Social is a private law firm consulting firm that's owned by Best Lawyers. We're very gratified by this recognition from one of the country's leading social media consultants for law firms.

Let me first of all introduce our speakers today and then give you a little bit of background about the topic we're going to get into, and then I have a lot of questions to pose to my guests today. First of all, I want to introduce Dru Stevenson. Dru is the Wayne Fisher research professor and professor of law at South College of Law in Houston. Dru has been a law professor for 20 years, obtained his JD at the University of Connecticut and his Masters of Law at Yale Law School. Dru mostly teaches professional responsibility, administrative law and law and economics. I learned about work that Dru was doing in this area through a publication that I very frequently look at, a publication of the University of Pennsylvania program on regulation. Publication is called The Regulatory Review, and on March 7th, I read an article written there by Julia Englebert called The Myth of Operation Choke Point. Yes, I said Operation Choke Point.

Remember that? It was, I would guess probably 10 years ago, maybe even longer, that was very much a front and center issue. A lot of people have forgotten about that and not really focused on it, and I hope you agree with me today after our program that this is an issue that needs to be examined because if you're in the consumer finance industry, it has the potential for still having a major impact on the customers that you do business with and how the regulators are going to view what you are up to. For those of you who don't know that much about Operation Choke Point, I decided to read to you the very brief description that I could find in the most authoritative resource that I could go to on the internet, namely Wikipedia. And this is what Wikipedia has to say about Operation Choke Point.

It was an initiative of the United States Department of Justice beginning in 2013, which investigated banks in the United States and the business they did with firearm dealers, payday lenders, and other companies that while operating legally were said to be at a high risk for fraud and money laundering. This operation disclosed in an August, 2013 Wall Street Journal story was officially ended in August, 2017, and the FDIC settled multiple lawsuits by promising Congress additional training for its examiners and to cease issuing informal and unwritten suggestions to banks. I became very interested in that topic because at the time I did a lot of work both for payday lenders and for banks that were lending to payday lenders.

And I'm not talking about the operations that I think a lot of people would agree are subject to great scrutiny, I'm not talking about offshore payday lending, I'm not talking about partnerships that were developed between Native American tribes and payday lenders where the parties were relying on sovereign immunity in order to launch a program. Those aren't the kind of payday lenders that I ever represented. I represented the legitimate ones, the law-abiding ones, some of them large, some of them medium size, and some of them actually pretty small, and they were really under siege and having great difficulty when Operation Choke Point was at its apex. let me now introduce our second speaker. First of all, I almost forgot to wish you a very warm welcome, Dru. Pleasure having you on our show today.

Dru Stevenson:

Thank you. I'm honored to be here.

Alan Kaplinsky:

Great. Our second guest today, as I said on these shows, I like to present diverse viewpoints, and I think I've accomplished that objective. We'll see how it turns out. But let me introduce to you Brian Knight, who's a senior research fellow and lead scholar of the Financial Regulation Program at the Mercatus Center at George Mason University. Brian obtained his JD from the University of Virginia. His research interests have included innovation in financial services, but currently mostly focuses on the politicization of financial regulation and financial services and its use as a tool of universal regulation. He says his other interests include firearms, barbecue, and he said being mediocre at jujitsu. I'm not sure I want to be in the same room with you, Brian. I'm glad we're doing this virtually, but all kidding aside, a warm welcome to you Brian, as well.

Brian Knight:

I might have barbecue here and I will say I aspire to mediocrity in jujitsu. I currently clearly reside in the bad section, so I wouldn't worry too much.

Alan Kaplinsky:

All right. Okay, so let's get into our program. First going to start, I have a number of questions for both of you, but I'm going to talk about your Law Review article for a moment that was published in the Administrative Law Review. What year was it published, Dru?

Dru Stevenson:

Last year, in 2023.

Alan Kaplinsky:

Okay. It's available in the Administrative Law Review, or I believe you can obtain it at the website SSRN. Am I right? You can-

Dru Stevenson:

That's correct.

Alan Kaplinsky:

You can download it, you can print it out, you can read it. Tell me what prompted you to write an article on Operation Choke Point, something that was in its prime a long time ago. We're talking 10 years ago maybe. Why now?

Dru Stevenson:

Well, I write a lot about firearms regulation and policy, and something that's been happening in the last three or four years is a number of state legislatures have been considering bills, and in my state, in Texas, they actually enacted it that are anti-boycott statutes that basically debar any company from doing business with the state or a municipality if they discriminate against a firearms manufacturer or dealer or anyone involved in the firearms industry, which gives special protected status to them. And then there's an exception for if there's non-firearm related reasons to think that it's risky that you don't want to deal with them. And this has had actually a huge impact because it excluded from our state the largest national banks that were doing the lion's share of municipal bond underwriting, so it's become much more difficult and expensive for municipalities to get an underwriter for their bond issues in Texas.

And as a result of this law, they passed it at the same time as an anti-ESG law that's designed to basically protect the fossil fuel industry as well, and when I went through the legislative history of this, a lot of the discussion was actually about Operation Choke Point. And so the way that this is being promoted or talked about in the state legislatures is that they're saying that Operation Choke Point was essentially a program to de-bank the firearms industry. They never mentioned payday lenders. And that this was then privatized somehow by the banks themselves, and so we have to do something to basically force the banks to be willing to do business with the firearms industry. And so the more I dug into Operation Choke Point and what this was, the more it seemed like there was an imaginary fairy tale about what happened and then maybe a more realistic story about what it actually was and had happened to it, and so I got to it because of these anti-boycotting statutes that are now quite a fad for state legislators every year.

Alan Kaplinsky:

Yeah. And of course, while it seems like the focus now is on the firearms industry in particular, this is not an issue that only relates to firearms. It could relate to 10 years ago it was payday lending, but it could relate to other kinds of lending or FinTech operations that are going on. Am I right?

Dru Stevenson:

Yes.

Alan Kaplinsky:

It's a universal issue.

Dru Stevenson:

And in fact, the majority of the bills that I referenced that have been adopted and that introduced are more focused on ESG, like punishing banks that are limiting how much they'll do business with the fossil fuel industry and things like that, and that's the hot issue right now is the ESG movement and the requirements from the EU for financial institutions and then this backlash basically in the conservative states.

Alan Kaplinsky:

Yeah, you call your article Operation Choke Point Myths and Reality, so yeah, I see where you're coming from, but let me go to Brian. What is your general reaction to Dru's article?

Brian Knight:

I'm going to perhaps for the first and last time on this podcast, agree with Dru in the sense that if we look at Operation Choke point, the DOJ program, the actual effect of that is one, really hard to suss out, and there's a lot of debate about it depending on who you look at, but it is, at least I have not seen conclusive evidence that specific program was some deep dark plan to attack things. However, if you view the phrase Operation Choke Point the same way we view something like Watergate, that it becomes a phrase, a catch-all for a type of conduct, I do think you're on stronger ground to say that there is a history of bank regulators using their power to try to discourage banks from doing business with legal, but disfavored industries, and also that there is a argument to be made that banks on their own trying to cut off certain industries.

And I think we can distinguish firearms from fossil fuels in the sense that there is a constitutional element to firearms. We can debate the exact scope of it, but there is something there that probably doesn't exist for fossil fuels, and so without necessarily endorsing the anti-boycott bills, a legislator can say, "As part of my role in protecting my citizens' rights, including their Second Amendment rights, I am going to use the law to counteract banks attacking gun businesses," whereas with fossil fuels or something else that doesn't have that constitutional valence, that looks more like industrial policy. That looks more like, well, for the economy or for whatever reason, I'm going to do this, but it doesn't have that constitutional element to it.

Alan Kaplinsky:

Right. Right. I got it. Let's dig into this subject because there are a lot of interesting subtopics that relate to Operation Choke Point. And let's start with you Dru, and that is what role should bank regulators play in the modern economy? Should they focus exclusively on safety and soundness, or should they try to accomplish broader social purposes?

Dru Stevenson:

Well, I think that obviously the primary focus is always going to be on financial safety and soundness, but part of the crux of the debate about the ESG and its backlash against it is whether reputational risk or regulatory risk are a type of financial risk. And so I don't think you can ever completely separate the two because for example, if it's very obvious that the EU has passed some very stringent regulations about something or that there's a move to go back to the firearms industry, a number of states are adjusting their statutes, for example, to make it easier to sue firearms manufacturers, that we are talking about things that could affect risk. And so some of this is going to be in the eye of the beholder and the people who love the fossil fuel industry are going to say this is all political. If I could give another example, when I was growing up, I would never in my life have thought that vaccines were a political issue, getting children vaccinated and things like that.

I knew that there were people who didn't want to do it and had objections to it, but it only takes one side to make something a political issue, and then it's a political issue and everything about that. And so we could be having this same conversation about basically bankrolling vaccine companies, and maybe we could say that that's not political, but if it is to someone and they have enough influence, they can make anything political. Now, I agree that this can be abused and it's harder to quantify some of these more theoretical risks, but I do think that there is some place, to use Brian's phrase, for industrial policy to encourage banks to provide funding for development of new sustainable energy sources and things like that, that we know we want. Or silicon chips, the high-tech chips for computers that we could encourage that and then discourage industries that for a lot of public policy reasons we think are harmful for our country to be focused on or dependent on.

Alan Kaplinsky:

I'm going to ask Brian's reaction to what you've just said, but before I do that, having been a banking lawyer for practically my entire career, there's something that I find offensive in anyone, regulator or anyone else, congressman or public policymaker or the President of the United States telling a privately owned bank that's owned by, sometimes they're privately owned in the hands of one family, very often it's a publicly owned bank, who they should lend to and who they should not lend to. There are restrictions under federal law, there are anti-discrimination provisions under the Equal Credit Opportunity Act and the Fair Housing Act. You can't discriminate in making a loan on the basis of sex or race, or marital status and a number of other enumerated bases, but short of that, it should be up to the bank to... If they don't want to lend money to a firearms dealer, why shouldn't they be able to do that? Why should the state interfere with that? Maybe I'm speaking to the choir here, but get your reaction then I'd like to go to Brian.

Dru Stevenson:

Well, look, I'm not suggesting that I approve of regulators just basically dictating every little loan, like having to approve every loan the banks make or every bank customer, but we have had to approach this both with the problem with narcotics trafficking and with human trafficking, things like that, that probably people on whatever angle you're coming from politically agree that human trafficking is bad and it's illegal, but for every illegal industry, they also depend on certain supporting industries or wraparound industries. We had this earlier in our nation's history with the import of slaves, of individuals from Africa for slavery, and well, that really depended on the shipping industry.

And so then the question was can we boycott or could a regulator somehow discourage the shipping industry from leasing boats or shipping for the transport of slaves? And so I'm not saying that I approve of all of this, but I'm saying at some point you can say, "We need to follow the money, and if we have something that is two steps away from something, we want to discourage that there could be some place for some moderate regulation that involves not just financial policy, but social policy."

Alan Kaplinsky:

Yeah, yeah. Everybody, I think we all agree safety and soundness is the main thing that regulators need to focus on, but as you pointed out, included within that very general term is this concept of reputational risk, that even if you set up a program that you're a bank and you're lending money and you do the appropriate due diligence on somebody who has applied for a loan and you determine they're in compliance with the law and you don't see a problem there and you decide to lend money to that company or to that individual, the regulators have always had the right to talk about reputational risk. And if they think that that type of lending, and a lot of the regulators thought if you were engaged in payday lending that had a stigma attached to it, and if that became public and there were articles in the newspapers about it, people who don't like payday lending might stop doing business with your bank. They might withdraw their funds, take their deposits out, and that's something that existed way before Operation Choke Point. Anyway. Brian, what's your reaction to what Dru had to say?

Brian Knight:

Unsurprisingly, I'm pretty skeptical for a few reasons. One, if we're talking about legal industries, as you mentioned, everything is controversial to somebody, and the risks you run... To have a world where the regulators are using their power in the name of safety and soundness to discourage doing business with legal industries, to have that actually work, ideally the regulators have to be able to accurately assess which industries are truly controversial enough that they pose a threat to safety and soundness and how to manage that while also avoiding substituting their own preferences in and trying to be even-handed and fair about it. And I don't think there's any reason to believe regulators are capable of that, and that's not a slight against the regulators, it's that they're humans, but the problem is, if we have a world where, well, maybe such and such regulation or industry is legal, but it's disfavored and we want to start cutting at it, well, who gets to make that determination?

It's one thing to say something like human trafficking where that is a crime, but it's another thing to say that for something like fossil fuels or guns, or abortion, or whatever, and actually in the wake of the Dobbs decision where suddenly abortion could be outlawed at the state level, would we want our bank regulators to go to the pharmaceutical companies that make supporting pharmaceuticals and be like, "Hey, man, you need to really be thinking about this?" That makes me uncomfortable, and I'm actually looking at a paper published in the American Journal of Political Science by Furnace and LaPira about... And they did a study of elite opinion, including civil servants, and what they found is that elites tend to have what they call an egocentric view, which is that people believe what I believe. Look, I think that's true of almost all of us, but those of us who aren't in government don't get to have government effect put to those beliefs. And so I don't think the regulators are in a good position to assess that.

Another problem is, well, how serious does a threat need to be? And there's a split in the circuits on this where some circuits say, "For something to be unsafe and unsound, it has to threaten the stability of the bank." Other circuits say, "Any economic loss, any additional economic loss is enough." And so if you go to a bank and you say, "Hey, you're doing business with controversial industry A and some people may not like that," does it have to be enough people that they're going to threaten the stability of the bank if they pull out, or does it have to be, well, just potentially anyone? And that gets really vague and allows a lot of discretion on the part of the regulator that I don't think we should be comfortable with, and so that's a thing that I think we do need to be worried about.

Alan Kaplinsky:

Yeah. Well, let me ask you this. I want to drill down just a little bit. I get your point, and I largely agree with it, but should the bank, assuming the regulators aren't applying any pressure, what's wrong or right about the board of directors of a bank deciding, we all, the entire board, we think guns are out of control? We don't want to have anything to do with them. And we think that practically all of our customers, let's assume the bank is located not in Texas, of course, but in a liberal progressive community in Massachusetts, in some suburb of Boston, where practically all the people are in favor of gun control. Is it okay for that bank located in that local community to say, "We don't want to do business with gun manufacturers or gun stores?" What's wrong with that?

Brian Knight:

Well, so if I might plug some research I did with a former colleague, we did a paper published in the New York University Journal of Law and Liberty that looks at why you may want to be skeptical of that, or at least the reasons that need to be factored in. And part of it is banks are different from other industries and are granted a significant amount of protection and significant amount of power by public policy. There are barriers to entry, there are barriers to exit, they get preferential access to government services, they get preferential access to certain legal regimes, as you know well from your work with bank and non-bank lenders. And it's worth asking, well, why do we do that? And if the answer is to facilitate an economy, a bank coming in and saying, "Well, we want to frustrate part of the lawful economy because we think that is bad," does raise questions about whether or not that's an appropriate use of all of that power.

And obviously a small local bank in Farnham Massachusetts poses a different risk than Bank of America because Bank of America has a lot of power and a lot of position, and if you pull them out of the market, as Dru was referring with the municipal lending, if you pull the big players out of the market, prices go up, which is entirely to be expected. And so, banks in particular, I think pose interesting questions that would not be posed by industries that don't rely so much on government power and aren't so entwined with public policy. And if I could just make one other note here about reasons to be skepticism about this concept of reputation risk is it also provides an incentive for people to try to work the ref, if you will, and say, "Well, maybe we can't directly target industry A or group A or whomever, but if we can get the bank regulator convinced that we will pull all of our money out, they're going to lean on the bank."

And you mentioned the Equal Credit Opportunity Act. Part of why religion and national origin are protected classes is in response to the Arab boycott of Israel and Jewish businesses, and the concern that the Arab states were going to use their economic leverage over banks to be like, "Well, if you want my business, you can't do business with Israeli firms." And so part of the government's reaction to that's like, "Well, look, we're just going to take religion and national origin off the table." And that allowed the banks to say to Arab governments, "I can't do that, and neither can anyone else. Your two choices are to quit asking me or leave the American banking system." And they quit asking. And so we could add other protected classes are what the legislature wants them to be so we can add or subtract there.

Alan Kaplinsky:

Right. Got it. Got it. And by the way, just as a footnote here, the CFPB has taken the position that any form of discrimination, any type of discrimination, even if it's not prohibited by the Equal Credit Opportunity Act or the Fair Housing Act, it runs afoul of the prescription of engaging in unfair, deceptive or abusive acts or practices. They have been challenged about that, there was a lawsuit brought in Texas, and at least at the district court level, the CFPB lost where the court concluded they could not find discrimination to be an unfair trade practice. Anyway, let me go back to you, Dru. I want to get into, again, back to the regulators and back to, is it their role to promote certain kinds of policies that are considered to be good policies? If some policy focus is inevitable or appropriate, where do you actually draw the line, or how much of this is too much or is government overreach overly politicized?

Dru Stevenson:

I probably agree with both of you that that's the hard question, is that it is hard to say where do you draw the line? I think that's true with a lot of regulatory decisions and policy. I don't think the fact that the line is hard to draw means we should just make a categorical rule that nobody's allowed to do this. And again, I want to circle back to if you think about money laundering, why do we care about money laundering? Well, because it's activity that is often kind of legal, right? You have some shell corporations and different escrow accounts and money being cycled through, and a lot of the individual transactions are legal, but this is used to fund terrorist groups overseas and domestically, and drug cartels and things like that, things that I think most all of us here would agree are a problem.

And so I do think that at some point you're going to have the bank saying, "Look, you've watched Breaking Bad, I watched Breaking Bad, we know that there's certain industries that deal with a lot of cash transactions that are the favorites for money laundering, and we want you to look extra hard at that." The other thing I want to say about this line drawing is sometimes when we talk about this, we make it sound like each individual one loan regulator has unfettered discretion and that you have no... You're just at the mercy of their whims and caprice. And I think on the one hand, anytime you have someone who has power, you're never going to get away from the fact that they operate with personal biases and unconscious biases towards certain parties or parts of town, or parts of the country, or things like that. And so if we have human beings involved and they're given power to dictate what other human beings do, they play favorites, on the one hand.

On the other hand, it's not just that we have some lone regulator who doesn't like guns or wants to be a vegan and doesn't want to support the beef industry or the poultry industry, or something like that, and that you... These are large organizations that make policies, a lot of the stuff is carried out on the retail level by a lower level civil servant, but at the top level, you do have policy makers. And then as you just gave an example of someone who felt like they were the victim of some unfair targeting, and they went and got recourse in the courts, and you're often going to have that.

And so this isn't just saying, "If we take one step in this direction, we're at the mercy of some bureaucrat who may be an ideologue or a fanatic about some political issue." We still have a functioning court system, and those agencies have hundreds, a lot of times thousands of employees, and they have meetings and discuss things. They get called in to testify before Congress and explain what they're doing and why. And so I'm not as worried that Darth Vader is in control of the FDIC, and there's simply nothing you can do about it.

Alan Kaplinsky:

Right. Right. Brian?

Brian Knight:

Okay, once again, I disagree, and I think if you look at the FDIC's OIG report on refund anticipation loans, what you saw is that there was this cascade from the very top where Sheila Bair gets a letter from an advocacy group saying, "Hey, these refund anticipation loans are bad." She looks at them like, yeah, these are gross. Not they're economically inefficient, not they're dangerous to safety and soundness, just, ew, these are bad. And it goes down the chain until you have very abusive interactions between the examiners and the banks, and I will say that I think I would argue that with banks in particular are actually, and this has been changing recently, and we should note that, but historically, banks have been loathe to sue their regulator because even if you win, you still have to deal with your regulator, and they have a million different ways to make your life hell.

Alan Kaplinsky:

There is a CFPB exception to that rule.

Brian Knight:

Right. Well, but also, banks operate in a relatively opaque environment where things like supervisory information is kept private by law and all of that, and so it's fair to say, "Well, if there was fire, shouldn't there be smoke?" The counter argument is, "Well, not if the fire is in one of those rooms where they have a giant hood that sucks the smoke away," and banking is at least uniquely well suited to that. The other argument on reputation risk, and particularly I'm talking about reputation risk of legal businesses, legal activities as opposed to money laundering, which is a crime. Congress has come in and criminalized it, and yes, the individual act in and of itself is not a crime, but intent and purpose give it a criminal nature, and that's what the government has to prove up. But for lawful businesses, it's that it's also unclear whether or not this model actually helps fulfill legitimate purpose, which is does this type of enforcement actually make banks more stable?

Are they less prone to failure? And there's precious little evidence of that. And so if we have these costs, do the benefits outweigh them? I agree, if men were angels we wouldn't need to worry about government abuses, but if men were angels, we wouldn't need a government in the first place. And I acknowledge that just because something is not going to be done perfectly, that's not necessarily a reason to not do it. On the other hand, we do have to ask, given the potential risks and challenges and problems, is it worth it? And if it isn't, then why run that risk? I agree that if banks doing things like concentration risk analysis, banks doing things like compliance risk analysis, or bank regulars I mean, okay, yeah, that credit risk analysis, that all makes sense, but does the reputation risk standing on its own actually add anything that's worth the potential risks?

Alan Kaplinsky:

Right, right, right. Want to ask another question. We've already touched on the answer, but maybe there's a little bit more to add. And that is some banks already have an incentive to cut ties with controversial customers where it doesn't make sense economically or financially, where they don't think they're going to get the kind of rate of return, but they're looking for in order to generate enough profits for the shareholders of the company. Are bank regulators uniquely well suited to assess the risks that are posed by controversial customers as opposed to the banks themselves?

Dru Stevenson:

That's part of what brought me to the subject, honestly, is that the largest banks and the national banks after the Parkland School massacre basically announced that they were going to start backing away from companies or entities in the firearms industry that made or sold assault rifles specifically. It wasn't like a ban, like we hate guns or something, it was a specific type of thing. And of course, the people... There's a media for each side of the aisle and people said, "Oh, look at these woke managers," but they're also dealing with activist shareholder proposals at their board meetings, and there's a lot of moving parts in these things with these policies, but yes, I agree. What brought me to this is in a lot of our red states now we have policy that's trying to prevent banks from doing their own risk analysis, free market analysis of which industries they just think are too messy.

And so on the one hand, I do think that's true. On the other hand, I think that we have in our nation's history examples where it's just too tempting. The companies that are laundering money, let's say for drug cartels and terrorist groups overseas and stuff like that, you can make a lot of money. And so at some point, there's a reason for, I think a justification for regulators to step in and say, "We are worried about this industry and we are worried that you are giving them a pass because the money is just too good." And in the process of that, our thwarting policy that has been adopted by Congress, and as we said, money laundering is a crime, but we mostly enforce that through our scrutiny of these financial institutions. And that's the way we find it, people are very clever about these things.

Brian Knight:

Well, so I think that the problem we run into, one, we should note that at least based on their rhetoric, the banks after Parkland didn't frame their decision just as like, "Oh, this industry is messy or we're not into it." It's Congress should be doing something. They're not, we will." And that I do think is a problem, and I think that's part of what triggered so much of the response is, oh, we are going to in effect try to de facto regulate this industry. And I will say that I think everyone should be uncomfortable with that given the amount of power that banks have been granted by public policy, not to be regulators, but to be facilitators of lawful commerce. The other part of it is, going back to the money laundering issue, I think there is a distinction between supervision picking up on activity in support of a illegal enterprise, the act of supervision versus the act of supervision for pure reputation. It's one thing.

And when the bank regulator goes to a bank and says, "Hey, your AML KYC is inadequate," they don't say primarily... And people won't like that. They say, "Well, that's not compliant with the law, or that could be facilitating unlawful transactions," and the regulators in a much stronger position legally, I think a much stronger position philosophically, if they're grounding that in those things rather than we worry or we don't like the reputation of this industry that you're serving, because why should the OCC or the FDIC or whomever be the people to make that particular call? And if we want to criminalize additional things, if we want to make things illegal, we have a process for that and involves the legislature and involves courts and all of that good stuff. If we're not doing that, allowing the bank regulators to try to facto do that or separately allowing the banks to de facto do that is more problematic, and so I think we need to be worried about that.

Alan Kaplinsky:

Yeah. Well, I'll tell you one of the things that really bothered me, and it goes back to the payday lending industry, and it goes back to this concept of rent-a-bank where payday lenders wanted to make payday loans in certain states where they couldn't economically do it because the usury laws were too restrictive. They very often partnered with either national banks or state banks who had federal usury authority to charge whatever interest was permitted by the law of their home state and to export that interest around the country, and there were all kinds of joint ventures that had been entered into, and all of a sudden they were all quite profitable and they were all very much fostering competition, which you would think would be good for consumers. But yet at certain points, because of the pressure applied to them on the regulators by consumer advocacy groups, I think practically all of them hated the product payday lending.

They wanted it banned, done with. They didn't want it just regulated, they wanted it done. Eventually, the regulators, the FDIC, the Comptroller of the Currency told all their banks, "Get out of that business. We don't want you in the business." And once that happened, that was the end of those so-called rent-a-bank arrangements. Today, that's morphed into, it's not payday lending anymore, but there are all kinds of joint ventures between FinTech companies who are making consumer loans and mostly state chartered banks who are doing the same thing. They're using the state chartered banks to take advantage of their usury authority. So far, the regulators, at least the FDIC has turned the other way. They don't seem to be quite as concerned about it, but I detect that with pressure starting to build among consumer advocacy or raising the issue of does this make sense to allow the banking industry to be involved in enabling FinTechs to do an end run around state usury laws? What do you think of that, Brian?

Brian Knight:

I tend to support the ability of banks to partner with other institutions, and from a policy point of view, I want as much competition in credit markets as possible. I acknowledge that... Look, I don't agree as a policy matter, but Colorado is doing what Colorado is entitled to do and withdrawing from [inaudible 00:45:12] and all of that. I guess there's the process question and then there's the outcome question, and we have processes in this country designed to protect people, and you may not like the outcome, but the process itself is important.

What I worry about are these end runs that you're describing where it's like, well, we can't win enough votes or that pesky constitution gets in the way, but you know what? If we can capture or convince a relative handful of regulators, well, that's almost as good. That gets us to where we want to be, or at least close to where we want to be. That's the thing to be worried about, and so far, a lot of what we've discussed is coded left, but look, imagine a second Trump administration where the OCC is leaning on abortion drug makers or whatever, and they'll have advocacy groups leaning on them. They will have the same political considerations. It's going to be the same song just sung in a different key, and that makes me really uncomfortable too because I don't think we want our bank regulators to play that role in our society.

Alan Kaplinsky:

I've got some questions I just want to run through in rapid fire fashion, Brian, for you, and would you say that your objection to Operation Choke point, or put another way, having regulators apply undue pressure regulating institutions, is it mostly based on the adverse effect or what you feel were bad intentions of the program or the way in which it was carried out?

Brian Knight:

Yes. Yes, all three bother me. All of them bad.

Alan Kaplinsky:

Okay. All right. And Dru?

Dru Stevenson:

I think Operation Choke Point was fine, and I do think though that I would say the one aspect of that that I think we should talk about is I have agreed all along that we should have concerns about financial regulators imposing or forcing, being too overreaching or being too coercive with their ideologies. I think there already are a lot of checks and balances in place for that. I think talking about people's intentions is so subjective that it's a meaningless discussion. How bad were they? This was actually a lot of the discussion about in the NRA versus Vullo case that the Supreme Court heard this term, and the real question is, well, what was really going on? And that's an objective thing that we can talk about. To go back to your example, how bad was it for the payday loan company? It's really hard to prove that the firearm industry was hurt by Operation Choke Point.

The congressional hearings are a bunch of people just coming in and complaining that it was hard for them to get a loan for their mom and pop gun store. Well, guess what? The nail salons and restaurants have trouble getting loans for their small businesses as well, but if you want to talk about what happened with the payday loan industry, I don't think we should talk about... It's not going to be helpful for... I don't like payday loans, I understand that other people do, but I'm with the consumer advocates on this, and it's too tempting to just say, "Well, somebody's viewpoint disagreeing with me is some sort of sinister intention." But I do think we can talk about what effect does this really have, and did we effectively shut down that industry and did that have adverse consequences? And I agree that that's a fair conversation to have, but I don't agree with, let's have a categorical rule that we're never allowed to do this because something bad might happen.

Alan Kaplinsky:

Right. Brian, overall, do you think it's appropriate for federal agencies to regulate risk-taking by financial institutions or potential threats to their solvency, or reputational risk and regulatory risk, the types of financial risks that could affect investors and customers?

Brian Knight:

Before I answer that question, could I just respond to one thing Dru said? And that's I do think intent or motive, if you will, matters in part because there are some times where motive is a factor as to whether or not something is permissible or not. Dru mentioned the Vullo case, which is a First Amendment case in bank and insurance regulatory trapping. Well, how the government, if the government's trying to restrict speech based on viewpoint, that is relevant to that analysis. And if what we see is regulators saying, and this is what the OIG and the FDIC OIG found in the payday and refund anticipation loan cases, is that you have regulators being like, "I hate this stuff. It's bad, it's gross." Not illegal, but bad and gross. And so it should be driven out of the banking system because the banking system shouldn't be involved in bad, gross things.

That is a world of difference from, hey, we've done the analysis and actually these things do pose a real risk to the stability of this bank, because one is value neutral and you could trust the regulator if instead of something they dislike it's something they like, still being like, "I like this stuff, but it's still going to be a danger to the stability," versus, well, the things I dislike get the ax and the things I like I'm not looking at. I think that is a problem, particularly in areas where individuals have a ton of discretion like bank regulators. Now, to segue into your actual question about risk taking, so look, I'm somewhat skeptical of bank regulators' ability to do this type of risk-based analysis, and I think the fact that we've had a series of bank failures in the past year that seemed to be catching the regulators by surprise is at least we're thinking about does this model work and would we be better served doing some other model like just requiring banks to sit on a lot more capital or something like that?

And the problem that you get with this type of thing, especially if the risk is not tied to some objective criteria, is that people do substitute their personal judgment perhaps subconsciously, perhaps unintentionally. We all do it, but I think that's the risk. Now, if instead what you're dealing with are things that have more of an objective analysis like concentration risk, like credit risk where you can go back and do the math, or compliance risk or legal risk where you can go back and look to some authoritative body of law, that's less objectionable, but I do think that... And the other thing is on potential threats to the solvency. That's the issue we raised earlier where when we say threat to solvency, do we mean an objective threat to solvency or do we mean any economic loss?

Because yes, in theory, any economic loss if it spuns out long enough, could be a threat to solvency in theory, but banks lose money all the time and they're fine. And banks do things... Wells Fargo had a massive fake customer scandal and it did not threaten their solvency, which is weird when you think about it, so if a bank having internal policies that encouraged their employees to lie, to create false accounts using people's personal information didn't threaten their solvency, how worried should we be about mere reputation risk involving a bank's customer? Not even the bank's acts themselves.

Alan Kaplinsky:

Dru, any reaction?

Dru Stevenson:

Yeah, so obviously I think that part of why our country is prosperous is because the regulators have policies that create a lot of predictability and stability, and that if we withdraw that, I think it's fine to always ask these questions like maybe we should require more capitalization and focus less on individual industries, because that's too easy of a workaround or something like that. But I want to go back to the Vullo case for an example to highlight the problem with talking about intentions. The NRA did something illegal. They were offering a product that was objectively illegal. They had to pay fines, their underwriters had to pay fines for that, and so the problem in the case was that the regulator put out statements that were couched in the moment, which was everybody was horrified about what had happened at Parkland.

And so it was a very strongly worded thing about how terrible guns are and the problems that they're doing in our society, and so again, it's in the eye of the beholder. I look at what the NRA did, and I think why are they above the law? Why don't they have to... If they're going to offer an insurance product, they should have to go through the same rules and comply with the same regulations as every other company that offers insurance products. They shouldn't get to be special because somebody says, "Well, guns are in the Constitution." But the regulator was very open about her opinions about guns in general, and so depending on which side of the case you're on, the NRA of course claimed they were being persecuted for advocating for what's a Constitutional right. And we could probably argue for all day about whether firearm commerce is protected by the Constitution, by the Second Amendment or not.

I think you have to really read a lot into it to see that in the Second Amendment, but the fact is that they said they were persecuted. It's pretty clear from oral arguments that some of the justices on the Supreme Court thought, "Oh yeah, look at the stuff that this regulator said publicly, her press releases and what the governor said is even worse, and so therefore bad motives. The NRA is being targeted." And then I look at it and I say, "It doesn't really matter how strongly she felt about the company or the industry, or guns, or children in schools, they objectively did something illegal that anyone else would've been fined for." And I don't like the NRA, and so to me, I get indignant that they think they should be above the law just because other people are enthusiastic about them.

Alan Kaplinsky:

Well, I'm going to give you, Brian, the last say here.

Brian Knight:

For your listeners' understanding, Dru and I are on opposite sides of this. We each were part of briefs on opposite sides. And for listeners to understand one, the posture of that case is on a motion to dismiss, so the issue is the Second Circuit said, "Even if everything the NRA alleged is true, it doesn't matter," and I think that's an thing to keep in mind is it is entirely possible the finder of fact will find that, yeah, the NRA violated insurance law and got fined appropriately and no harm no foul, that's a possibility. But the other thing is of course, the guidance documents that were sent out were not limited to the NRA, did not mention flaws in affinity insurance program, it was all about gun control and it was all about don't do business with the NRA or similar gun promotion groups, no matter how squeaky clean they may be on the insurance front.

I look at the Vullo case and yes, I too, I have a different perspective and I look at it as like, "Yeah, this is a nightmare because you have your bank and insurance regulator quite explicitly politicizing their regulatory function to achieve an alternative end," and I would hope I would be, and if I'm not, you can all yell at me and shame me for this, equally appalled if you reverse the politics of it, because that is just not what bank regulation or insurance regulation should be.

Alan Kaplinsky:

Okay. Well, I want to thank both of you, Brian and Dru, for just a very illuminating discussion of Operation Choke Point and related subjects. Once again, my thanks to both of you. To make sure you don't miss any of our future episodes, please subscribe to our show on your favorite podcast platform, be it Apple Podcast, Spotify, YouTube, or wherever you listen. And don't forget to check out our blog consumerfinancemonitor.com for daily insights on the financial services industry. And there actually is a lot of content on there, none of it really recent pertaining to Operation Choke Point. If you have any questions or suggestions for the show, please email us at podcast, that's singular, at ballardspahr.com and stay tuned each Thursday for a new episode of our show. My thanks to all of our listeners and have a good day.