Cracking Down on Fraud?

BY TIM SABLIK

In the wake of the financial crisis, President Obama established the Financial Fraud Enforcement Task Force. Led by the Department of Justice, the task force brought together financial regulators like the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve as well as law enforcement agencies like the Federal Bureau of Investigation in an effort to increase detection and prosecution of financial fraud. In a March 2013 speech, Michael Bresnick — then executive director of the task force — outlined a strategy that has since been dubbed "Operation Choke Point." Regulators would press banks to closely review their merchant accounts and weed out accounts held by fraudulent payment processors and other businesses in "high-risk" sectors.

The FDIC issued guidance on its website identifying categories of businesses that might pose "legal, reputational, and compliance risks" to banks. The list included illegal operations, such as Ponzi schemes and cable box descramblers, as well as businesses that are legal in many states, such as ammunition and firearm merchants and payday lenders. The FDIC stated that while many of these firms are reputable, as a whole they operate in sectors that have been increasingly associated with illegal or deceptive practices. According to the FDIC, these businesses often gain access to the payment system through nonbank payment processors and then charge consumers for "questionable or fraudulent goods and services." Banks are required to conduct due diligence of their customers under the Bank Secrecy Act (BSA), but nonbank payment processors are not subject to such laws and therefore may indirectly expose banks to greater risk.

In January, the Department of Justice filed suit against Four Oaks Fincorp and Four Oaks Bank & Trust Company in North Carolina for allegedly granting a payment processor that served several fraudulent online payday lenders direct access to the Automated Clearing House payments network. According to the complaint, Four Oaks received notifications from customers of the payday lenders that their accounts were subject to activity they did not authorize, and prosecutors argued that Four Oaks did not respond to these and other signs of fraudulent activity. Four Oaks agreed to pay $1.2 million to settle the charges.

Operation Choke Point has largely focused on such online payday lenders, which have increasingly been the subject of consumer complaints. In October, Pew Charitable Trusts released a report noting that those who borrowed online suffered much higher rates of fraud than storefront payday borrowers. Online lenders were also more likely than storefront lenders to issue threats to borrowers and engage in other illegal activity. A third of online borrowers reported unauthorized withdrawals from their bank accounts and two in five had their personal or financial information stolen. Pew noted that such practices were not universal, however. The largest online payday lenders were the subjects of very few complaints, and the majority of offenses were concentrated among lenders that were not licensed by all the states in which they operated.

In addition to licensing, several states regulate lending through usury laws limiting the maximum annual interest rate that lenders can charge. Some customers of online lenders reported interest rates far in excess of these limits — more than 1,000 percent in some cases. A few states, including North Carolina, ban payday lending entirely. But states have had difficulty enforcing the rules on unlicensed online payday lenders, which often operate out of other countries or through Indian tribes and claim not to be subject to state laws.

While regulators say that their efforts have been directed at these illegal lenders, some lawmakers argue that Operation Choke Point may go too far and unfairly punish legal lenders and merchants as well. In May and December, Rep. Darrell Issa, the chairman of the House Committee on Oversight and Government Reform, issued reports arguing that the Department of Justice and FDIC used Operation Choke Point to target legal but disfavored businesses like payday lenders. Citing emails among FDIC officials that suggested "personal animus towards payday lending," the reports argued that the FDIC acted inappropriately by injecting those beliefs into the bank examination process. At a July hearing, House Judiciary Committee Chairman Bob Goodlatte said that he had "received numerous reports of banks severing relationships with law-abiding customers from legitimate industries" that were designated high risk.

Studies have shown that payday lenders can fill an important niche for some consumers. Even consumers who have access to checking accounts or credit cards may choose to use payday loans if the fees are cheaper than the alternatives, such as overdrawing an account or failing to make credit card payments on time. Indeed, research by the New York and Kansas City Feds in 2008 and 2011 found that after North Carolina and Georgia banned payday loans, households experienced higher rates of bounced checks and bankruptcy relative to those in states that allowed payday lending.

In June, a major trade group representing payday lenders filed a lawsuit accusing financial regulators of attempting to drive payday lenders out of business. In the same month, Rep. Blaine Luetkemeyer on the House Financial Services committee introduced legislation to end Operation Choke Point. In response, the Department of Justice and FDIC agreed to launch a preliminary investigation of the program. The FDIC also removed the list of specific high-risk business categories from its guidance to depository institutions. **EF**

Editor's Note: The third paragraph reflects corrections made in May 2015 to details of the Department of Justice's suit. See online version of this article for more information.