REVAMPING AND REVITALIZING BANKING IN THE 21st CENTURY

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House Financial Services Committee

February 8, 2023

Good morning, Chairman Barr, Ranking Member Foster, and members of the Subcommittee on Financial Institutions and Monetary Policy. It is an honor to testify before you.

My name is Brian Knight, and I am the director and a senior research fellow for the Program on Innovation and Governance at the Mercatus Center at George Mason University. Much of my research focuses on financial regulation and innovation. Any opinions I express today are my own and do not necessarily reflect the views of my employer.

The purpose of this hearing is to discuss the role of small and community banks and how they can better serve the public. This topic is timely and important, and touches on a host of issues. By necessity I will limit my testimony to only a couple of issues.

Specifically, I intend to discuss the following key themes:

1. Innovation and collaboration with innovative non-bank firms are important tools small banks can use to offer high-quality services and compete on a more even footing with bigger banks.
2. Transparent and accountable regulation is critical to protecting competition and the rule of law.
3. Congress can help foster innovation, competition, and appropriate regulation.

INNOVATION AND COLLABORATION WITH INNOVATIVE NON-BANK FIRMS ARE IMPORTANT TOOLS SMALL BANKS CAN USE TO OFFER HIGH-QUALITY SERVICES AND COMPETE ON A MORE EVEN FOOTING WITH BIGGER BANKS

Small banks provide critical services to millions of Americans. However, the business of banking is changing, in large part due to technology. Advances in communications and analytics have transformed banking services. This is having significant reverberations in the banking market. For example, the merger of two large banks—BB&T and SunTrust into Truist, which is now the seventh largest bank by

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assets in the United States[1]—was driven in large part by a perceived need to achieve scale in order to pay for the technology necessary to compete.[2]

An average community bank is not likely to be able to merge its way to the scale of Truist. So what can it do? One important option is to partner with innovative service providers that can leverage technology beyond what the average community bank can afford in order to assist with a range of functions, including customer acquisition, intake, and underwriting.

There is evidence that these technological innovations can help provide better service. The use of alternative data in underwriting has been shown to provide better pricing for loans, especially for those borrowers with limited credit histories.[3] There is also evidence of fintech firms increasing availability of credit in relatively underserved markets.[4] For example, there is evidence that during the Paycheck Protection Program (PPP) fintech enabled loans to be extended at higher rates to the smallest businesses, minority-owned businesses, and businesses without a preexisting relationship to a lender.[5]

While the high-tech firms often get the lion's share of the attention, there is often a bank partner that is equally important. The fintech firm provides technology and customer acquisition while the bank provides capital and expertise, including on matters of compliance. This relationship can be quite valuable for both parties. Returning to the PPP, small banks like Cross River Bank helped enable loans to over 100,000 borrowers in the early days of the program.[6]

Of course, nothing is perfect. Some fintech lenders have been identified with having significantly higher fraud rates on PPP loans.[7] To some degree, this is the dark side of lending to borrowers who lack a preexisting relationship; in other cases, it appears that insufficient due diligence was conducted. Even here though, the value of the bank partnership is apparent. As the Select Subcommittee on the

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[1] https://www.federalreserve.gov/releases/lbr/current/

[2] https://www.cnbc.com/2019/02/07/ballooning-tech-budgets-and-pressure-from-fintech-drive-bank-mergers-like-bbt-and-suntrust--.html

[3] See e.g. Marco Di Maggio, Dimuthu Ratnadiwakara, and Don Carmichael, "Invisible Primes: Fintech Lending with Alternative Data" (NBER Working Paper 29840, Cambridge, MA, March 2022), https://www.nber.org/system/files/working_papers/w29840/w29840.pdf; and Julapa Jagtiani and Catharine Lemieux, "The Roles of Alternative Data and Machine Learning in Fintech Lending: Evidence from the LendingClub Consumer Platform" (Federal Reserve Bank of Philadelphia Working Paper 18-15).

[4] See e.g. Douglas Cumming, Hisham Farag, Sofia Johan, and Danny McGowan, "The Digital Credit Divide: Marketplace Lending and Entrepreneurship," *Journal of Financial and Quantitative Analysis* 57, no. 7 (November 2022): 2659–92, https://www.cambridge.org/core/services/aop-cambridge-core/content/view/57BFF4D1063F34BA4217F39A4BAE52B4/S0022109022000357a.pdf/div-class-title-the-digital-credit-divide-marketplace-lending-and-entrepreneurship-div.pdf.

[5] See e.g. Jessica Battisto, Nathan Godin, Claire Kramer Mills, and Asani Sarkar, "Who Received PPP Loans by Fintech Lenders," Liberty Street Economics Blog, New York Federal Reserve, May 27, 2021, https://libertystreeteconomics.newyorkfed.org/2021/05/who-received-ppp-loans-by-fintech-lenders/; and Jessica Battisto, Nathan Godin, Claire Kramer Mills, and Asani Sarkar, "Who Benefitted from PPP Loans by Fintech Lenders," Liberty Street Economics Blog, New York Federal Reserve, May 27, 2021, https://libertystreeteconomics.newyorkfed.org/2021/05/who-benefited-from-ppp-loans-by-fintech-lenders/; and Isil Erel and Jack Liebersohn, "Can FinTech Reduce Disparities in Access to Finance? Evidence from the Paycheck Protection Program," September 2021, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3650510.

[6] https://www.nytimes.com/2020/06/23/business/paycheck-protection-program-cross-river-bank.html

[7] Select Subcommittee on the Coronavirus Crisis Staff Report (December 2022), https://coronavirus.house.gov/sites/democrats.coronavirus.house.gov/files/2022.12.01%20How%20Fintechs%20Facilitated%20Fraud%20in%20the%20Paycheck%20Protection%20Program.pdf.

Coronavirus Crisis noted in their report, some bank partners were able to insist on improved due diligence and compliance with their fintech partners, likely reducing the rate of fraud.[8]

Small banks will be better able to compete with larger banks if they can partner with other firms to provide capabilities that they cannot afford to produce on their own. Unfortunately, some regulatory developments, including the use of the Congressional Review Act on the OCC's rule clarifying the power of national banks to make and sell loans as well as the general regulatory burden, imperil the value of bank partnerships. While some regulation of these relationships is most certainly appropriate, we must be certain it is not excessive or unfairly penalizes small banks compared to their larger rivals. Which brings me to my next point.

TRANSPARENT AND ACCOUNTABLE REGULATION IS CRITICAL TO PROTECTING COMPETITION AND THE RULE OF LAW

The relationship between government and banks is unique. Banks rely on a host of protections and privileges provided by law.[9] Likewise, banks are regulated in a more intimate and intense manner than almost any other industry. This makes it all the more important that bank regulation be transparent, accountable, and consistent with the law and the Constitution of the United States. It is here that Congress should play a more active role.

Unlike almost any other industry, banks are subject to ongoing supervision by their regulators[10] that, in the name of protecting the safety and soundness of the bank, can exercise a significant degree of managerial control over how banks conduct their business. Much of this power is exercised outside the view of the public and involves regulators enjoying significant discretion.[11] The nature of a bank's relationship with their regulator contributes to banks feeling they are bound by what should be nonbinding guidance and makes them loathe to challenge their regulators in court for all but the most serious issues.[12]

Unfortunately, there is evidence that this dynamic has resulted in past abuses of regulatory power, where regulators used nominally nonbinding guidance and nebulous concepts like "reputational risk" to discourage banks from providing their services to certain legal industries because the regulators themselves disfavored those industries. The most notable examples are the efforts of FDIC employees to prevent banks from working with Refund Anticipation Loan providers and payday lenders.[13]

Regarding the case of Refund Anticipation Loans, FDIC employees generally could not cite to a violation of law, but rather relied heavily on the concept of reputational risk as justification to pressure

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[8] Id. at 74–78.

[9] See generally Brian Knight and Trace Mitchell, "Private Policies and Public Power: When Banks Act as Regulators within a Regime of Privilege," *NYU Journal of Law and Liberty* 13, no. 1 (2019): 66.

[10] Statement of Margaret E. Tahyar before the Committee on Banking, Housing, and Urban Affairs, United States Senate, April 30, 2019.

[11] Id.

[12] Nicholas R. Parrillo, "Federal Agency Guidance and the Power to Bind: An Empirical Study of Agencies and Industries," *Yale Journal on Law and Regulation* 36, no. 1 (2019): 165.

[13] See generally Federal Deposit Insurance Corporation, Office of Inspector General, Report No. OIG-16-001, Executive Summary, "Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel" (February 2016) (the FDIC OIG did not release the full report because it contained "sensitive information"); and FDIC OIG Office of Audits and Evaluations, Report No. AUD-15-008, "The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions and Conducted Business with Merchants Associated with High-Risk Activities" (September 2015).

banks to exit a legal line of business.[14] While this guidance was in theory nonbinding, there were instances where refusal to comply resulted in banks being subjected to aggressive and sometimes unprecedented supervisory pressure,[15] as well as having business plans rejected unless banks acquiesced to the FDIC's "guidance."[16]

In the wake of a second scandal, this time aimed at payday loans, the FDIC clarified via new guidance that banks that can manage risks are not prohibited from serving lawful customers.[17] As part of the settlement of a lawsuit brought by payday lenders, the FDIC also acknowledged that the actions of certain employees were inconsistent with FDIC policies and created "misperceptions about the FDIC's policies."[18] The FDIC also denounced "regulatory threats, undue pressure, coercion, and intimidation designed to restrict access to financial services for lawful businesses."[19] However, no legal changes have occurred with regard to the FDIC's authority.

My intention with these comments is not to say that such abuse is universal or even necessarily common but to highlight the inherent arbitrariness in our current bank regulation model, so that Congress can more effectively exercise its role to both oversee regulations and establish the legitimate scope of regulators' authority.

A persistent problem is that bank regulation can be highly opaque and present numerous opportunities for a regulator to harm a bank without taking formal action, and banks have a strong incentive to not resist regulator pressure even if the regulators are exceeding their authority.[20] This opacity makes it hard for Congress, the public, and potentially even the agency's leadership to know if regulators are exceeding or abusing their authority.[21]

Another insidious problem is that bank regulators claim power that is hard to delimit. For example, under the OCC's definition of reputational risk,[22] anything that lowers a bank's reputation with one of a long list of stakeholders, including the regulators themselves, could pose a "reputational risk" that threatens the safety and soundness of the bank, which the OCC may intervene to correct.[23]

Some courts have cabined the definition of unsafe and unsound practices based on reputational risk to apply only to cases where the risk might pose a significant and concrete threat to the bank's financial condition.[24] But this view is explicitly not accepted by the OCC[25] and does not appear to be taken as

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[14] Id. See also Julie Hill, "Regulating Bank Reputation Risk," *Georgia Law Review* 54, no. 2 (2020): 523.

[15] FDIC OIG Office of Audits and Evaluations, Report No. AUD-15-008, 39-40.

[16] Id. at 38.

[17] FDIC OIG Office of Audits and Evaluations, Report No. AUD-15-008, 19.

[18] Letter from FDIC Deputy General Counsel Floyd Robinson to David H. Thompson, May 22, 2019, https://www.fdic.gov/news/press-releases/2019/pr19040a.pdf.

[19] Id.

[20] Parrillo, supra note 12, at 194–95.

[21] The FDIC OIG found that while the chairman of the FDIC asked FDIC management to look into potential abuses of power related to RALs, FDIC management failed to "accurately or fully describe the abusive behavior." Federal Deposit Insurance Corporation, Office of Inspector General, Report No. OIG-16-001, iii.

[22] *OCC Controller's Handbook, Large Bank Supervision*, version 1.2 (March 2022), 34–35.

[23] Hill, supra note 14, at 560–61.

[24] Gulf Federal S.&L. Assn. of Jefferson Parrish v. Federal Home Loan Bank Bd., 651 F.2d 259 - Court of Appeals, 5th Circuit 1981; Johnson v. Office of Thrift Supervision, 81 F.3d 195, 204 (D.C. Cir. 1996); Seidman v. Office of Thrift Supervision, 37 F.3d 911, 928 (3d Cir. 1994); and First Nat'l Bank of Bellaire v. Comptroller of the Currency, 697 F.2d 674, 681 (5th Cir. 1983). See also Hill, supra note 14, at 558–60.

[25] Hill, supra note 14, at 558.

binding by other regulators.[26] Nor is it accepted by all courts, with some courts declining to require a substantial threat to the stability of the bank for an act to be considered unsafe or unsound.[27]

A third problem is the lack of meaningful independent review of a bank regulator's supervision. While a bank facing regulatory overreach could in theory sue, the structural incentives the bank faces, especially if they are not one of the large and wealthy banks, strongly discourage doing so. This significantly diminishes one of the most powerful tools for both transparency and checking regulatory overreach: the courts.

Likewise, the value of regulators' internal review processes is debatable. For example, the FDIC recently disbanded a meaningfully independent internal review process staffed by former FDIC officials with supervisory experience and returned to a process that provides significantly less independent review.[28]

CONGRESS CAN HELP FOSTER INNOVATION, COMPETITION, AND APPROPRIATE REGULATION

Congress can and should help address these problems. Not because the regulators are inherently malicious—I don't believe they are. But rather because the nature of the regulatory system creates poor incentives for all involved. Congress should help provide salutary clarity and ensure that regulatory process can accomplish its important mission consistent with Constitutional and legal limits.

The first thing Congress should do is engage in vigorous oversight. I say vigorous, not aggressive, because I hope this need not be adversarial. Rather, Congress should engage fully with the regulators and regulated entities to get more insight into how regulators use their power, where potential issues lie, and what changes may be appropriate.

The second thing Congress should do is ensure that regulators' material supervisory decisions can be appealed to a truly neutral third party. While I am uncertain whether there are Constitutional implications to internal review boards, either internal or external, reviews should be truly independent from the agency's management.

Finally, Congress should provide more clarity as to the scope of regulators' authority. At a minimum, Congress could make clear that for something to be an unsafe or unsound practice, there must be a harm that is concrete rather than speculative and poses a significant risk to the bank's financial condition.

Congress should also consider explicitly eliminating things like reputational risk from regulators' purview. As Prof. Julie Hill notes, reputational risk has been the source of significant controversy and

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[26] Hill at 560-61.

[27] Hill at 560, citing Gully v. Nat'l Credit Union Admin. Bd., 341 F.3d 155, 165 (2d Cir. 2003); Greene Cty. Bank v. Fed. Deposit Ins. Corp., 92 F.3d 633, 636 (8th Cir. 1996); Cavallari v. Office of the Comptroller of the Currency, 57 F.3d 137, 142 (2d Cir. 1995); Doolittle v. Nat'l Credit Union Admin., 992 F.2d 1531, 1538 (11th Cir. 1993); and First Nat'l Bank of Eden v. Dep't of the Treas., 568 F.2d 610, 611 n.2 (8th Cir. 1978).

[28] 87 FR 77112; See also Brian R. Knight and Thomas M. Hoenig, "The FDIC Should Restore the OSA or, at Minimum, Solicit Public Views Before Regressing to the SARC" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, June 13, 2022), https://www.mercatus.org/research/public-interest-comments/fdic-should-restore-osa-or-minimum-solicit-public-views; and Brian R. Knight and Thomas M. Hoenig, "The FDIC Should Restore the OSA or, at Minimum, Solicit Public Views Before Regressing to the SARC: Guidelines for Appeals of Material Supervisory Determinations" (Public Interest Comment, Mercatus Center at George Mason University, Arlington, VA, November 8, 2022), https://www.mercatus.org/research/public-interest-comments/fdic-should-restore-osa-or-minimum-solicit-public-views-0.

potential abuse, and risks harming the reputation of regulators as well as the regulated. Further, it is unclear whether there are any legitimate threats to safety and soundness that are covered by reputational risk that are not covered by other, more objective risk types, such as legal or credit risk.[29] Removing vague concepts like reputation in favor of more objective criteria should help improve trust in the regulatory system and make it more effective.

Small and community banks are an important part of the American economy as they provide needed financial services to a significant segment of the population. Congress and regulators should foster an environment that enables innovation and permit collaboration between small banks and fintech firms. Congress should also clarify the scope of regulators' authority to make bank regulation more transparent, objective, and resistant to misuse.

Thank you again for the opportunity to testify. I look forward to your questions.

[29] Hill, supra note 14, at 530-34.