Chairman Luetkemeyer, Ranking Member Clay, and members of the committee:

I appreciate the opportunity to testify today. My name is J.W. Verret; I am a professor of banking and securities law at the Antonin Scalia Law School and a senior scholar with the Mercatus Center at George Mason University.

The legislation under consideration today includes vital reforms to the bank examination process by banking regulators, to the Consumer Financial Protection Bureau’s (CFPB) jurisdiction and enforcement powers, and to the statutes enforced by the CFPB. These changes will help to provide more certainty and predictability to banks, and they will begin to alleviate barriers to entry which have made it all but impossible to open new banking institutions in recent years. These new provisions will help to ensure economic growth and access to financial services for all Americans.

It is critical that regulatory barriers to bank competition and to customer access to financial services be removed. The committee’s attention to these important issues is commendable, and it is consistent with other moments in banking history in which Congress was compelled to address inefficient barriers to competition in the banking system.

As the dual banking system evolved over the 150-year period since the Bank Act of 1863 was first adopted, a number of states set up intentional barriers to entry to prevent out-of-state institutions from competing with home-state banks, and consumers suffered.

Congress and federal regulators eventually stepped in to promote interstate branching, first through holding companies and eventually through efficient preemption of anticompetitive state rules. We stand at another such juncture, where congressional action will be vital to renew our banking system.

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At times, preemption of state regulatory barriers will be necessary, particularly with respect to the nascent financial technology industry.

In more recent history, a failure of multiple federal banking regulators to coordinate their de novo bank processes, rules, examinations, and enforcement proceedings has similarly led to unnecessary barriers to entry, excessive compliance costs, and harm to consumers. As in the past, Congress can play a vital role in renewing our banking system.

The examination process for banks is unique in the American regulatory structure. In no other field of regulation is the relationship between regulator and regulated so tightly knit. Examiners take up residence within institutions. Communications to a bank examiner are provided limited legal privilege from discovery, a privilege otherwise reserved for one's lawyer, spouse, or physician.

The exam process can work well and help remedy financial problems specific to a particular banking institution without harming the bank's reputational capital. The unique nature of examination can, however, turn quite ugly. Banking institutions report that examiners have sometimes issued retributive threats for opposing rules in a public notice-and-comment process or have issued inappropriate demands that amount to shadow regulation.

Furthermore, bank regulators have shown an unwillingness to coordinate bank examinations. Banks are in a constant state of examination and sometimes have to balance conflicting demands from different examination teams. The ideas reflected in the legislation we will discuss today can begin to ameliorate some of those problems, and I commend this committee's attention to these solutions.

The CFPB is one of the most powerful regulators in the financial services space, yet it is also the youngest. The Federal Reserve is more than a hundred years old and, the Office of the Comptroller of the Currency dates back to the Civil War. These agencies benefit from regulatory culture and a wealth of legal precedent defining their operative statutes, which have evolved collectively over hundreds of years. The CFPB, on the other hand, is five years old, and I don't need to remind this committee of the growing pains it has experienced.

It is therefore entirely appropriate that the CFPB's operative statute, and the statutes it enforces, be continually refined. I would argue that one of the most important changes being considered today is the proposed change to the broad authority of the CFPB to prevent unfair, deceptive, or abusive acts or practices.

Words have power in the law, and word choice in statutes is particularly important. They have power because they can be defined over hundreds of fact patterns in which impartial judges give words meaning. The words “deceptive” and “unfair” have such a clear meaning, developed over decades of implementation by the Federal Trade Commission, but the word “abusive” does not.

In the realm of political soundbites, it is easy to accuse someone making a legitimate argument about statutory meaning of being “in favor of abusive products.” It's an old Washington trick. I would, however, challenge any who oppose this statutory change to describe a set of facts that would be considered abusive but not unfair or deceptive.

Another piece of legislation under consideration today would establish an intent requirement for violations of the Equal Credit Opportunity Act (ECOA). The CFPB describes itself as a law enforcement agency, and indeed the penalties it collects are often large enough to blur the line between civil and criminal actions. Our criminal laws overwhelmingly require an intent or “scienter” element to offenses,
recognizing that unintentional actions taken by people doing their best to follow the law are not morally blameworthy.

Courts interpreting ECOA have recognized this need for an intent requirement, and they have required either intentional or reckless behavior in order to award punitive damages under the statute. 2 Recent settlements under ECOA have reached levels that would have previously been reserved for punitive damages awards under the statute, and so I would argue the statutory fix contemplated today is consistent with the original intent of ECOA and with legal precedent interpreting the statute. I would further argue that a clear reading of the ECOA statute indicates it does not permit actions based on a theory of “disparate impact,” further bolstering the argument that the change contemplated today merely recognizes an existing feature of the statute.

I also commend the committee’s attention to the use of reputation risk in bank regulation and supervision. Citing to amorphous reputation risk has become a new fad among bank regulators in recent years, both in justifying rulemaking and in the CAMELS rating process, and it is highly problematic.

First, regulators have yet to demonstrate that reputation risk is a necessary component of the CAMELS rating and examination, since existing financial and management measures would capture the effect of any reputational problems among bank customers.

Second, regulators refuse to use the empirical tools available to measure reputation risk, such as stock price event studies or hedonic consumer price studies. Instead, they use reputation risk as a vague way to justify their personal preferences. The close association between this regulatory tool and the recent Operation Chokepoint scandal suggests careful scrutiny is warranted.

Reform of the examination process, of the CFPB’s powers and statutory authority, and of the use and abuse of reputation risk in bank examination and regulation will go a long way toward pruning the regulatory thicket that has stifled new bank formation in recent years. The various bills today present a wealth of ideas, only a handful of which I have touched upon. I look forward to discussing them with you.

I thank you for the opportunity to testify, and I look forward to answering your questions.

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2 See, for example, Fischl v. General Motors Acceptance Corp., 708 F.2d 143 (5th Cir. 1983).