Commentary: The Rise of Bank Substitutes and Why It Will Continue

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Industry continues to grow and accumulate political clout, one may expect to see more states changing their laws, further feeding the growth of pawnbroking.

The next several years may also bring additional growth in the commercial check-cashing industry as entrepreneurs open new outlets in relatively underserved cities. Over the long run, however, this industry will undoubtedly be threatened by the rise of electronic payments. A number of states are already switching to electronic benefits transfer to deliver welfare and food stamp benefits and the private sector is increasingly encouraging employees to use direct deposit for wage payments. Although these developments have not yet affected the majority of check-cashers’ customers, it is likely only a matter of time before clever developments in electronic payments begin to replace checks and money orders.

Bibliography


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By Alvin C. Harrell

I. Introduction

A number of trends in banking and consumer finance have become evident over the past ten years, including: (1) A decline in the number of small community banks, (2) a dramatic reduction in the number and aggregate deposits of community thrift institutions, (3) a decline in the number and an increase in the average size of national banks, and (4) a significant increase in the market share of nonbank entities offering financial services traditionally supplied by community banking institutions. These trends appear related and reflect the continuing consolidation of the banking industry, and a corresponding increase in consumer use of nonbank substitutes.

These trends can be objectively measured, and there should be no debate as to their existence and direction. At the same time, another trend has also been evident: There has been a significant increase in banking and consumer financial services regulation and litigation. Likewise, there can be little debate on this point: it is obvious that the legal and regulatory climate for banking institutions changed quite drastically after FIRREA, the Crime Control Act of 1980, and FDICIA, and the increase in consumer credit litigation and regulation over the past 25 years has been well documented in this journal and elsewhere.1

Beyond this, upon consideration of how these trends may be related, a consensus is more difficult to achieve. While it seems obvious to many that increased legislative and regulatory requirements, complexities and liabilities (and associated litigation risks) are destroying our 20th century system of broad-based consumer financial services providers and creating in its place a series of narrow market niches increasingly being served by entrepreneurial nonbanking entities, this may be discounted or even disputed by other observers. This lack of consensus, perhaps fueled by a hesitancy to confront the adverse effects of politically popular policy initiatives, has prevented policy makers from dealing effectively with the fundamental trends that are reshaping the financial system. As a result, the decline of independent community banking seems likely to continue, even as the powers, activities and size of individual banking institutions continue to grow. In turn, this will continue to expand the niches being filled by nonbank financial substitutes such as pawn shops. The purpose of this article is to highlight some of the often-overlooked factors

1. The validity of these observations is not affected by recent regulatory efforts to improve the value of the national banking system by allowing regulatory processes and granting expanded powers. This appears to represent an effort to preserve newly enhanced regulatory turf, and is unlikely to impact the basic trends noted above. See also infra Part III.

(Continued on page 16)
Pataki. As the regulations (as adopted in October of 1994) were scheduled to become effective on January 31, 1995, the Department was pressed to advise institutions what disclosures were required, so that appropriate forms could be created and distributed before the effective date. In late December, 1994, the Department issued a letter to several industry trade groups to the effect that, due to the inability to adopt final regulations based on their November proposal, it would not seek to enforce those provisions in Part 9 which required the periodic notice to appear on the face of the statement and which required the banking institution to issue the Notice and Acknowledgment form at the time of the opening of the account. 27

C. Amendments

At its meeting on March 2, 1995, the Banking Board adopted in final form, that part of its November proposal which eliminated the Notice and Acknowledgement form and which allowed institutions to issue the required periodic notice through the use of an insert rather than on the face of the periodic statement. The Board, however, did not adopt the third proposed change, the prohibition against the closing of an account with a zero balance unless it has been inactive for 90 days. 28

VII. Conclusion

New York's "basic banking" account is a reflection of a political philosophy which maintains that banks ought to be compelled to offer certain traditional banking services to the general public. Some disagree with this perspective and deem it over regulation of an industry that is already suffering from too much regulation and an uneven playing field against non-bank competitors. Banks have already pressured the Department to conduct a detailed study regarding the cost of providing a basic banking account—a study which many bankers hope will allow them to increase the $3 periodic service fee. 29 Meanwhile, New York's less affluent consumers may benefit not only from this new product but from the availability of other low-cost deposit accounts offered under Part 9's "alternate" account option. It will be interesting to watch the shape of future amendments and Department interpretations since the statute and initial regulations were passed under the liberal Democratic administration of former Governor Mario Cuomo, while the pro-industry amendments were adopted in March under the more conservative and pro-business Republican administration of Governor Pataki.

27. See, for example, Letter of Carmine M. Triga, Acting Superintendent of Banks to David Glass, General Counsel of the New York State Bankers Association, dated December 21, 1994.
28. 3 NYCRR Part 9, NY State Register, April 5, 1995. As this action was taken during the Regulatory Moratorium, the Department had no authority to issue an Order of Repeal. See 3 NYCRR Part 9, NY State Register, April 5, 1995. Under that Notice, comments on the adopted amendments could be submitted to the Department by May 5, 1995. (See Letter of Charles H. Williams, Secretary of the Banking Board dated March 31, 1995. On June 7, 1995 the Banking Board adopted the amendments at 2 NYCRR 9.3(a)(6) and 9.200 by unanimous written consent. Notice of adoption appeared in the NY State Register on June 28, 1995.

Commentary: The Rise of Bank Substitutes and Why It Will Continue

(Continued from page 12)

that are driving this trend, and to offer observations on what it may mean for consumer financial services in the 21st century.

II. The Impact of Technology and Regulation

Everyone is aware of the effects of new technology, which over a decade ago allowed securities firms to bypass traditional banking intermediaries by offering customers direct access to government securities as a substitute for FDIC insured deposit accounts. Indeed, it was this "disintermediation" that dramatically revealed the weaknesses of the post-war thrift regulatory structure, ultimately leading to elimination of the Regulation Q interest rate controls and wiping out most of the capital in the thrift industry.

In addition the effects of the Bush and Clinton-era legislative and regulatory initiatives are quite apparent and widely recognized. Everything from CRA and the Justice Department fair lending enforcement actions, to regulatory micro-management of banks, has been discussed and debated in the popular press as well as industry journals. These policy initiatives represent an effort to preserve and enhance a depression-era bank regulatory system, and to compensate for the resulting decline in the community banking institutions. However, the resulting regulatory burden has been counterproductive to these purposes. Numerous published reports provide examples of small institutions leaving the business as a result of the legislative and regulatory burden.

Clearly this burden, along with enhanced regulatory enforcement powers and micro-management of banking institutions, is contributing to the decline in the number of lenders that traditionally served local financial needs. The complexity and potential liabilities inherent in our consumer credit laws and regulations have complicated similar consolidation trends among other traditional consumer financial services providers, creating new market niches for those willing to assume the legal risks. But other, lesser known factors are also at work.

(Continued on page 28)
lowing the federal banking agencies to use a bank’s CRA performance record when considering an application by the bank. Such encouragement is needed because many banks have refused to lend in low- and moderate income areas (i.e., they have redlined) because they do not find it economically feasible to do so (perhaps because the default risk in those communities is considered too high). If banks believed it would be profitable to lend in such communities they would do so, and the CRA would not be needed in the first place. Thus, by requiring banks to do something they do not think is economically feasible, and which could lead banks to lend to higher risk borrowers, the regulators might be forcing banks to disregard “safety and soundness” considerations.

This dichotomy between fair lending requirements and safety and soundness concerns stems from the fact that unlike other banking laws, which are more directly linked to prudential considerations, fair lending laws are aimed at achieving a social goal rather than at insuring that a financial institution operates so as not to expose the deposit funds to unreasonable risks. In any event, the issue is not really whether fair lending requirements should be imposed on banks at all, but whether the fair lending requirements achieve their goal without imposing excessive burdens on the industry and without compromising the safe and sound operation of banks. So, on one hand the Clinton administration fair lending initiatives have tried to respond to public complaints about the alleged discriminatory and “redlining” activities of banks. On the other, though, the initiatives have also tried to respond to criticisms from the banking industry, which consider the fair lending requirements too vague, too difficult to comply with, and too burdensome. Hence, reform of the fair lending laws, such as the revision of the CRA regulations, has required a difficult balancing of not only socially motivated banking regulation with prudential considerations, but also the pressures exerted by community interest groups and the banking industry. The jury is still out regarding to what extent the November, 1994 Congressional elections may temper the fervor of the Clinton Administration and current U.S. bank regulators. Clearly these elections signaled a shift “to the right” in American politics. Banking industry representatives hopefully suggest that this marks the demise of federal government intrusion in the banking industry for social objectives. Notwithstanding the logic of this speculation, this author is not so sanguine, as the same was said regarding CRA and the COA and consumer-related banking legislation over a decade ago at the beginning of the “Reagan/Bush era.” Bankers and their counsel should be all too aware of what followed.

Commentary: The Rise of Bank Substitutes and Why It Will Continue

(Continued from page 16)

III. The Attack on Nonpurchase Money
Security Interests in Consumer Goods

When your author first entered banking in the early 1960s, the average consumer who needed money for a legitimate purpose could almost always get a loan at his or her local bank or finance company, at a reasonable rate of interest. If the consumer had no equity in his or her home (or did not own a home), and owed more on his or her car than it was worth (a likely scenario), the consumer could nonetheless secure the loan with household goods. For many consumers the combination of TV sets, appliances, furniture, clothing and household knickknacks that we all acquire was (and is) the only unencumbered property available for use as collateral.

Banks and finance companies were able to use such items as collateral for secured loans at lower interest rates than for unsecured consumer credit (which was, and is, typically unavailable beyond higher-rate credit card debt and the very small loans that qualify for exceptions to the usury limits).

Your author does not believe that most mainstream lenders are particularly fond of nonpurchase money loans on household goods; the loans typically were small by bank standards, and no lender is going to be enthusiastic about a loan secured by little more than the shirt on the consumer’s back. But these loans were important to the customers of banks and finance companies, and were extended quite regularly, at rates that would be considered a dream by today’s credit card holder or pawn shop patron. They were considered a necessary part of serving the lender’s community and customer base.

During the 1960s and 1970s there was a political and social reaction against such loans. The reaction was particularly acute among those who did not need such loans. Your author observed this sociological experience first-hand In the late 1960s, while working at a small suburban bank near Oklahoma City, your author participated in the repossession of a defaulting debtor’s household possessions. The description of the collateral in the security agreement was the classic “all household goods,” and the bank representatives rapped virtually everything in the house. It was an unpleasant experience that contributed to your author’s personal aversion to such security interests.

Nor was the bank pleased at having to auction off a load of old furniture and personal effects of minimal value. Your author’s recollection is that the costs of the repossession exceeded the proceeds of the sale. The bank was very pleased when changes in the law effectively precluded the bank from extending such loans; there was a general consensus that the bank ought not to have to deal with such customers anyway, and that they should go somewhere else. Well, they did.

The legal changes that mandated this change in bank policy were: (1) Section 552(f) of the Bankruptcy Code, which renders unenforceable in bankruptcy a nonpurchase money security interest in exempt household goods; and (2) the Federal Trade Commission Credit Practices Rule, which makes it an unfair trade practice to take a nonpurchase money security interest in consumer goods.

These developments effectively ended nonpurchase money bank lending on consumer goods. This was what your author likes to call “feel good” legislation and regulation: It made us all feel good that such abusive practices were being prohibited. This good feeling is especially prevalent among those of us who do not need to obtain, and do not want to extend, such credit. However, it left a sizeable market segment, including numerous moderate and even upper income borrowers, without access to nonpurchase money bank credit, creating a massive new market niche for pawn shops and small, high rate unsecured loans.

(Continued on page 16)
V. Conclusion

The decision to compete is never an easy one. About a decade ago, AT&T decided that competition was preferable to continued litigation with private parties and the Antitrust Division. Even though the transition costs may have appeared mammoth, it agreed to enter into a brave new world of long-distance network competition. What have been the results? Falling costs, flourishing product and systems innovation, dramatic growth for AT&T and other long-distance companies, and most important, the benefits of a competitive marketplace for consumers. This example of how network competition can benefit both consumers and competitors, should be carefully evaluated, as the future of duality is considered.

Commentary: The Rise of Bank Substitutes and Why It Will Continue

(Continued from page 103)

IV. Federal Regulatory Enforcement Powers

Despite all of the talk about reducing the bank regulatory burden, an issue that is not being debated is the enforcement powers of the federal regulatory agencies. Obviously those powers, and the accompanying risks and liability exposure of banks, were greatly enhanced by the Bush-era banking legislation,\(^1\), apparently as the result of a public perception that rogues in the thrift industry were primarily responsible for the deposit insurance losses in the 1980s. Congress concluded that effectively unlimited regulatory powers were the solution. Indeed, the extent and discretionary nature of these powers renders almost academic the debates over such matters as the new CRA regulations. As a practical matter, individual institutions are largely powerless to contest federal enforcement initiatives, whether founded in law and a formal regulation or not.

It is difficult to pin down the precise effects of the factor. As your author has pointed out, the bank regulatory agencies always have enjoyed powers that are exceptional if not unique in the context of our legal and democratic traditions and institutions.\(^2\) Most banks instinctively will try to do whatever the regulators want, with or without a regulation. In a sense the additional powers created in 1989, 1990, and 1991 were unneeded and are redundant. But the Bush-era changes are also commonly viewed as having conferred the lack of any effective review or due process for the community banker who is accused of being his or her regulator. The recent fair lending initiatives by the Justice Department have reinforced this perception.

Apparently recognizing the problem, the banking regulators have adopted various appeal processes for those dissatisfied with an examiner’s judgment, and some banks apparently are satisfied with this arrangement.\(^3\) At least in one case this process includes a follow-up to ensure the examiner does not seek retribution again against those banks who use the appeal system.\(^4\) But it is very difficult to gauge the effectiveness of such systems. For one thing, the scope of the appeal is very limited and the ability of any self-contained agency to police itself, without a system of independent checks and balances, must be questioned in light of broad-based historical experience.\(^5\) Similarly, the Justice Department may have backed away from some of its more extreme positions, but no one knows if this discretion will survive the next election. In effect, the current system remains dependent on the goodwill of the regulatory agency whose judgment will be questioned as a part of any legal defense. This is a system that depends on benevolence, not law. When dealing with a federal banking agency, one seemingly abandons the constitutional protections that most Americans still take for granted.

As noted, it is difficult to gauge the effect of this on consumer financial services. It is difficult to determine whether banks in general are even aware of their changed legal position, much less whether it is affecting career and merger decisions on a wide scale. But it is clear that the new legal and regulatory environment has a disproportionately heavier impact on small, closely held institutions, which previously tended to consider themselves private independent businesses but now must confront their new role as branch administrators of a national public utility.

Moreover, a small institution cannot pay a sufficient salary to compensate for the new legal and regulatory risks being assumed by its staff. A professional manager or attorney for a large institution, with a large salary and perhaps few nonexempt personal assets, can justify the risks and hope that his or her career will not spin the next banking crisis. The owner, operator or board member of a small institution, perhaps with a sizeable personal estate and only modest income from personal service to the institution, cannot reasonably justify the legal and regulatory risks he or she is taking. It is not surprising that a decision to leave the business, and perhaps sell the institution, may result.

To the extent that this is a problem, there is probably no way to fix it. Spooked by memories of the 1980s deposit insurance crisis, both Democrats and Republicans support stringent safety and soundness regulation. This makes true regulatory reform very unlikely. Short of proposals to reduce or eliminate federal deposit insurance (which banks adamantly oppose, for obvious reasons), there seems no likelihood that bank regulatory enforcement powers will ever be rolled back in a significant way. And despite the current public relations blit by the federal banking regulators, it seems inevitable that these regulatory powers ultimately will be used to impose a social agenda in the guise of “compliance” and micro-management of regulated financial institutions, resulting in a continued decline in community banking institutions.

V. Conclusion

No doubt there are many reasons for the rise of near-banks and other bank substitutes. But policy-makers understandably tend to overlook those causes that derive from recent and popular policy decisions, such as the crusade against the insiders of insolvent banking institutions, recent fair lending initiatives, and efforts to curb unpopular

(Continued on page 103)
ment of debt secured by real estate, servicers should obtain legal advice concerning whether an offset would be contrary to the one action rule.64

Also, if the borrower is awarded attorneys' fees under Section 6(f)(3), a servicer also might argue that the amount of attorneys' fees should be offset against amounts owed to the servicer under the ARM. Since there is no case law addressing the offset of attorneys' fees awarded under Section 6(f)(3), a borrower may argue that the rationale applied in TILA cases is equally applicable to RESPA cases. For example, in Plant v. Blazer Financial Services, Inc.,65 the court stated that attorney's fees awarded in a TILA case are not subject to offset against the debtor's outstanding debt to the creditor, regardless of any controversy regarding the underlying debt. The court reasoned that, because of the small amounts typically involved in TILA cases, to allow the setoff of attorney's fees would "thwart the statute's individual enforcement scheme and its remedial objectives."

5. Statute of Limitations

Because the statute of limitations set forth in Section 1566 only references actions brought under Sections 8 and 9,67 it is not clear how long a borrower has to bring an action based on Section 6. The appropriate limitations period may be incorporated from state law. Regulation X creates a limitation period for certain inquiries by stating that borrower notices delivered more than one year after a mortgage was transferred or paid in full do not constitute qualified written requests.68

V. Conclusion

RESPA's provisions provide procedures that are designed to lead to the resolution of mortgage servicing errors, such as ARM adjustment errors, without the need for litigation. Borrowers' attorneys should utilize the qualified written request procedure (1) to resolve matters without the need for litigation and (2) as to matters that can not be resolved, to obtain further information about potential errors and to perfect their rights under RESPA before filing a lawsuit. Servicers should take qualified written requests seriously in light of (1) their obligation to send timely responses and (2) the district court's holding in Froland v. Northeast Savings that a servicer is liable under Section 6(e)(2) for failing to correct an error after receiving a qualified written request concerning the error.

Commentary: The Rise of Bank Substitutes and Why It Will Continue

(Continued from page 103)

is also a danger that it will seek to protect its banking "partners" at the expense of other financial services providers by imposing restrictions that would damage the competitive position of bank substitutes.13 This would attack the remedy for prior public policy errors, while ignoring both the symptoms and the cause. The result would be a further consolidation and reduced competition in the financial services industry, likely accompanied by legal and regulatory efforts to fill the void with new federal programs. Indeed, there are some in Washington who will readily concede that federal credit allocation is the ultimate goal.

Absent further federal intervention, however, the continued movement of financial transactions outside the regulated banking system seems likely to continue, with near-banks continuing to fill the increasing gaps in the federally administered financial system.