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Lawsuit Signals Strategic Shift by 'Choke Point' Critics

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WASHINGTON - Payday lenders are raising the stakes in their pushback on Operation Choke Point with a lawsuit against banking regulators, alleging that "back-room pressure of banks" to dissolve longstanding relationships with payday shops and others is unfairly harming the industry.

The complaint, filed in the U.S. District Court for the District of Columbia on Thursday, charges that regulators, in conjunction with the Department of Justice, have crafted informal guidance for financial institutions that pressures banks to end business with payday lenders and other industries over concerns about "reputational risk."

The move comes on the heels of a major report released by the House Oversight and Government Reform Committee raising concerns about the Justice Department's law enforcement initiative, and follows growing criticism by lawmakers and industry officials alike.

"My suspicion is that this lawsuit is a reaction to the frustration of trying to find other ways to go about this," said Mark Calabria, director of financial regulation studies at the Cato Institute. "Payday lenders have tried to have conversations with DOJ and the banking agencies - that didn't work, so now they're going to court."

The complaint, filed by the Community Financial Services Association of America, a trade group for payday and short-term credit lenders, along with Advance America, a major payday lender, does not include the Justice Department, but instead focuses solely on the Federal Reserve Board, the Federal Deposit Insurance Corp. and the Office of the Comptroller of the Currency.

It alleges that regulators "are engaged in a concerted campaign to drive" payday lenders "out of business by exerting back-room pressure on banks and other regulated financial institutions to terminate their relationships with payday lenders."

Amy Cantu, a spokeswoman for CFSA, said that the lawsuit focuses on the banking regulators because the group believes they play "the central role in causing banks to terminate long-standing, mutually beneficial relationships with lawful, responsible businesses."

She added that "over time, we may find it necessary to add other agencies as defendants."

Observers said the lawsuit raises important questions about the limits of government efforts to root out fraud, when those efforts instead have significant impacts on a broader industry.

"Prudential regulators use the 'reputational risk' standard in safety and soundness to stop banks from doing almost anything they disapprove of, but there are limits, at least in theory," said Ronald Rubin, a partner at Hunton & Williams.

Justice Department officials have repeatedly argued that Operation Choke Point is intended to cut off fraudulent activity in various sectors, though critics charge that the initiative is unfairly chilling relationships with law-abiding payday lenders and is instead a pointed attack on a lending product the Obama administration doesn't like.

But the case could face a tough legal battle, because the Justice Department and banking agencies are not directly involved in cutting banks' ties to payday lenders.

"The best defense the regulators have is that they're not making anybody do anything - and it's really a question of how credible a judge believes that is," said Calabria, who added he still felt the case was "strong" because regulators have circumvented formal rulemaking procedures.

The banking agencies have instead relied on the use of informal guidance documents that raise reputation concerns over maintaining certain types of business. The payday lenders argue those materials lack transparency and don't provide an opportunity for industry comment.

"The difficulty for CFSA is that they're not challenging specific enforcement actions or rules, they're challenging regulatory guidance and investigations," Rubin added. "The agencies will probably reply that their guidance isn't binding and they don't know which businesses are dishonest until they investigate."

Bryan Hubbard, a spokesman for the OCC, said the agency does not comment on litigation, though he added that it is "not part of" Operation Choke Point.

"The OCC routinely cooperates with law enforcement agencies regarding their investigations and requests for information," he said.

A spokesman for the FDIC declined to comment, and a spokeswoman for the Fed said the agency is aware of the lawsuit and plans to respond.