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FEDERAL RESERVE BANK OF PHILADELPHIA

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No Cash 'til Payday: The Payday Lending Industry

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Payday lending has grown rapidly throughout most of the nation since 1990 amid substantial concerns raised by consumerists, legislators, government officials, and regulators. Over the past few years, some commercial banks have partnered with large payday loan companies or check cashing outlets to fund payday loans originated through such entities.

This article discusses the present payday loan or payday advance industry with a focus on the following:

- consumer protection issues related to payday loans,
- the legal and regulatory framework within which the payday loan industry currently operates, and
- the inherent risks to commercial banks that participate in payday lending activities.

What is a Payday Loan?

Payday loans, also known as payday advances or deferred deposit loans, are comparatively small, short-term, unsecured, single-payment consumer loans. Generally, payday loans are advanced in increments of $100, ranging in amounts from $100 to $500. Currently, fees charged on payday loans originated throughout the nation range from $15 to $30 on each $100 advanced. Because of the comparatively short duration of payday loans – usually two weeks – such loan fees result in three-digit and sometimes four-digit annual percentage rates. Stated another way, annual percentage rates for payday loans generally range between 400 and 1000 percent.

Payday loans are routinely marketed as a quick and easy way to get cash. The prevailing credit underwriting criteria of most payday lenders require that consumers need only proof of employment or a documented regular income stream, a personal checking account, and valid personal identification to receive a payday loan. Generally, upon presenting copies of a recent bank statement, pay stub or documentation of regular income, and utility bill, together with a post-dated check in the amount of the loan and the applicable fee, a payday loan applicant can receive a payday loan in approximately 30 minutes. Unlike traditional lenders, payday lenders do

IN THIS ISSUE

No Cash 'til Payday: The Payday Lending Industry CC1

Interagency FAQs on Regulation P CC4

CRA Sunshine Examination Procedures Released ... CC8

CIRCULATE TO:

☐ Compliance Officer

☐ Compliance Manager

☐ Compliance Staff

☐ _____

☐ _____

☐ _____

not request credit bureau reports from Experian, TRW, or Equifax. Instead, most larger payday lenders and banks that partner with payday lenders use consumer information services provided by Tele-Track, which is part of the Consumer Information Services Group of First American Corp. Tele-Track, based in Norcross, Georgia, offers credit reporting services oriented to subprime credit transactions and also provides credit scoring mechanisms to facilitate the origination of payday loans.

The Payday Lending Industry Today

The number of payday loan offices nationwide increased from approximately 300 in 1992 to nearly 10,000 by mid-2001 and is poised for continued growth. The Community Financial Services of America (CFSA), a trade association of the payday loan industry, has projected that about 180 million payday loans with a gross dollar volume of $45 billion will be originated throughout the United States during 2002. Payday loan originations are reported to be heaviest in the states of California, Florida, Texas, Tennessee, North Carolina, Illinois, Ohio, Indiana, Colorado, and Wisconsin.

At the beginning of the 1990s, payday loans were originated primarily by smaller independent check cashing outlets and pawnshops, which offered other services related to check cashing. By the mid-1990s, the industry had segmented to include large regional or national multi-service providers of payday loans and large regional or national monoline payday loan entities.

Multi-service providers offer payday loans as part of an array of various fringe banking services, including check cashing, money order issuance, bill payment services, and money wire transfers. Monoline entities, which have experienced sharp growth over the past five years, offer one product – payday loans.

The largest multi-service providers of payday loans are ACE Cash Express, Inc., based in Irving, Texas with 1,000 stores in 30 states; Dollar Financial Group, Inc., based in Berwyn, Pennsylvania with 700 stores in 24 states; and Cash America International, Inc., based in Fort Worth, Texas with 470 stores located in 18 states. The largest monoline entities are Advance America, Cash Advance Centers, Inc., based in Spartanburg, South Carolina with 1,375 stores in 30 states; CNG Financial Corporation, which operates Check N' Go, based in Mason, Ohio with 800 stores in 26 states; and Check Into Cash, Inc., based in Cleveland, Tennessee, with 650 stores in 24 states.

During the past few years, several commercial banks have entered into partnering arrangements with both large multi-service entities and monoline entities to offer payday loan products in those states having usury ceilings prohibiting the origination of payday loans by stand-alone payday lenders. Currently, about a dozen commercial banks throughout the nation fund the origination of payday loans under arrangements with either multi-product or monoline entities.

Consumer Protection Issues

Proponents of payday loans contend that a payday loan is a simple financial service product that addresses a temporary or emergency credit need that usually cannot be met by traditional financial institutions. They further argue that the current market pricing of the loans is commensurate with inherent risks of such loans and applicable operating costs. Moreover, they claim that the fees for payday loans are less costly to consumers than available alternatives such as bounced check fees and late fees associated with credit cards and utility payments. Proponents also contend that the industry is sufficiently regulated through existing state statutes and the best practices adopted by CFSA.

Critics of payday loans counter that the loans are usurious and that payday lenders target vulnerable consumers, namely lower-income persons, welfare-to-work females, military personnel, college students, and senior citizens living on fixed incomes. Critics also argue that most payday loan borrowers do not use payday loans as an occasional short-term emergency credit source. Rather, they contend that most borrowers become very frequent users and, in turn, become mired in an ongoing cycle of high-cost debt. Additionally, anecdotes offered by several consumer advocates cite instances of continuous rollovers of payday loans, payday loan customers having multiple payday loans outstanding simultaneously, and abusive collection practices on the part of payday lenders. The inclusion of mandatory arbitration clauses within payday loan contracts appears to be standard operating procedure among payday lenders and banks that partner with payday lenders to originate payday loans. More often than not, these clauses work to the benefit of creditors and to the detriment of borrowers. Finally, critics also argue that increased regulatory oversight of the payday loan industry is needed.

While proponents and critics may disagree over the benefits and detriments of payday loans, available data, including a comprehensive study released in April 2001 by the Credit Research Center of the McDonough School of

Business of Georgetown University, indicates that many payday loan borrowers transact payday loans on a frequent basis.[1] In particular, the Georgetown University study indicated that nearly half (48 percent) of the payday loan borrowers interviewed as part of the study had seven or more payday advances over a 12-month period. The Georgetown University study also found that, although 78 percent of the borrower interviewees said that they were provided with federal Truth In Lending disclosures, including the annual percentage rate (APR) on the loan, 72 percent could not recall the APR on the their most recent loan transaction.

Regulation Z requires detailed disclosures of the price and terms of consumer credit transactions, including the APR and the finance charge.

State Regulation and Legislation

Applicable state laws largely govern whether or not stand-alone payday lenders may originate payday loans. During the past decade, many states enacted or revised legislation to permit the origination of payday loans by stand-alone entities. Based on recent data provided by the Consumer Federation of America (CFA) and Public Interest Research Group (PIRG), 25 states and the District of Columbia allow payday-lending activities within their respective borders. Generally, state payday laws require payday lenders to be licensed and subject payday lenders to examinations to ensure they comply with applicable federal and state laws.

However, the legal and regulatory environments in some states that permit payday lending may be changing. For example, in July 2001 the Attorney General of Colorado filed a complaint against ACE Cash Express, Inc, (ACE) for unlicensed payday lending. ACE had surrendered its state supervised payday lender license when it arranged to make loans in partnership with California-based Goleta National Bank. The pivotal issue in this case is the question of whether or not a non-bank entity may use the federal preemption availed by the *National Bank Act* to circumvent compliance with Colorado's consumer protection laws. A final ruling is pending.

In another matter, North Carolina legislators allowed the state's payday loan law to lapse on August 31, 2001. As a result, several payday lenders have partnered with seven different commercial banks to preempt the expiration of the law that permitted stand-alone payday lenders to originate payday loans.

In August 2001, the Indiana Supreme Court upheld an opinion from the state's previous Attorney General that payday loans violate the state's civil and criminal laws. As a result of the ruling, some previously licensed lenders stopped originating payday loans. Some lenders devised variations on payday lending, claiming that the loans were now open-end credit. Others registered as loan brokers and debt collectors and partnered with commercial banks.

Federal Regulation and Legislation

In addition to applicable state laws, payday loans are governed by the federal *Truth in Lending Act* as implemented by the Federal Reserve's Regulation Z. Regulation Z requires detailed disclosures of the price and terms of consumer credit transactions, including the APR and the finance charge.

To date, the *National Bank Act* has served as a significant underpinning of the payday lending industry in many states that prohibit stand-alone payday lenders from originating payday loans. Under the *National Bank Act*, nationally chartered banks are able to export the interest rate charged in their home state to customers in other states. The *Depository Institutions and Deregulation and Monetary Control Act of 1980* allows state-chartered banks and other financial institutions accepting federally insured deposits to export rates across state lines. Further, the *Federal Deposit Insurance Act* declares that state-chartered banks are subject to the state law to the same extent that it applies to national banks. Thus, arguably, if national banks are excluded from

continued on page CC5

[1] See the Credit Research Center Monograph #35 *Payday Advance Credit in America: An Analysis of Customer Demand* at <www.gsb.georgetown.edu/prog/crc/order/Mono35.pdf>.

Interagency FAQs on Regulation P

On December 12, 2001, the Board of Governors of the Federal Reserve System, together with staff from the other federal agencies that supervise banks, thrifts, and credit unions, issued Frequently Asked Questions (FAQs) to assist financial institutions in complying with the privacy provisions of the *Gramm-Leach-Bliley Act* (GLBA) and the Board of Governors' Regulation P. These FAQs illustrate how certain provisions of the regulation apply to specific situations a financial institution may confront; however, they do not necessarily address all provisions that may apply to any given situation. Additionally, this guidance addresses a financial institution's obligations only under sections 502 through 509 of GLBA and Regulation P, and does not address the applicability of the *Fair Credit Reporting Act* or any other federal or state law that may pertain to the questions and answers.

The following is an excerpt from the new FAQs document.

A.2. Q. I am a small financial institution with no affiliates. I do not disclose information about my customers or consumers to anyone, except as permitted by an exception under sections 216.14 and 216.15 of the Privacy Rule. Does the Privacy Rule apply to a small operation like mine?

A. Yes. You have responsibilities under the Privacy Rule regardless of your size, affiliate relationships, or information collection and disclosure practices. The Privacy Rule is focused not only on regulating the disclosure of financial information about customers and consumers, but also on requiring each financial institution to provide initial and annual notices of its policies to its customers. You may, however, provide notice in a simplified form, as illustrated by the notice described in section 216.6(c)(5).

A.4. Q. I act as a custodian for Individual Retirement Arrangements (IRAs). Are the individuals who own the IRAs my customers?

A. Yes. An individual who establishes an IRA account for which you act as a custodian has obtained a financial product or service that is to be used primarily for personal, family, or household purposes; therefore, he or she is a consumer. When an individual selects you to act as custodian for his or her IRA, the individual enters into a continuing relationship with you and becomes your customer under the Privacy Rule. By contrast, an individual who is a participant or a beneficiary of an employee benefit plan that you sponsor or for which you act as trustee or fiduciary is not your customer because your relationship in that case is with the plan.

B.2. Q. I occasionally make business loans to sole proprietors. Do I have to provide them with a privacy notice?

A. Although a sole proprietor is an individual, if the sole proprietor obtains a loan from you for business purposes he or she is not a consumer for purposes of the Privacy Rule. Therefore, you do not have to provide any privacy notices to the sole proprietor.

The FAQs provide additional guidance on these and other topics, including:

- Financial institutions, products, and services that are covered under the Privacy Rule
- Individuals who are entitled to receive notices
- Delivering your privacy notices
- Providing notices to joint account holders
- Complying with the opt out provisions for joint account holders
- Delivering opt out notices and providing consumers with a reasonable opportunity to opt out
- Complying with the limitations on redisclosure and reuse of nonpublic personal information
- Complying with the limitation on disclosing account numbers
- Disclosing nonpublic personal information under the exceptions to the notice and opt out provisions
- Complying with the exception to the opt out provisions for joint marketing arrangements

The press release and the full report *Frequently Asked Questions for the Privacy Regulation* is available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/press/general/2001/200112122/default.htm>. ■

"No Cash 'til Payday:" *continued from page CC3*

certain state laws, so are state banks. Stand-alone payday lenders who enter arrangements with nationally-chartered and state-chartered banks routinely invoke the federal preemption available through the *National Bank Act* to export interest rates to states with interest rates caps or usury laws.

The federal preemption underlying payday loan origination arrangements between payday lenders and banks has raised considerable controversy. Critics of the payday lending industry contend that banks merely rent their charters to enable payday lenders to circumvent a state's usury laws or other restrictions. Proponents of payday lending counter that a legal framework has been firmly established to allow federally-insured banks to export interest rates and argue that, with respect to interest rates on credit cards, the courts have consistently held that the *National Bank Act* permits the exportation of rates.

In October 2000, two members of the U.S. House of Representatives, Melvin Watt and David Price, urged the Federal Reserve System, the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS) to issue federal regulations to address expanding payday lending activities. On November 27, 2000, the OCC and the OTS, which supervise nationally chartered financial institutions, issued advisory letters and guidelines to national banks and federal thrifts regarding contractual arrangements with third-party vendors to fund payday loans and auto title loans.[2] A joint statement issued by the OCC and OTS with the applicable advisory letters and guidelines included the following statement:

"…Finally, vendors who have targeted national banks and federal thrifts as a means of marketing such products free from state and local consumer protection laws should not automatically assume that the benefits of the bank or thrift charter will accrue to them by virtue of such relationships, or that the OCC or OTS will support such a position if challenges are raised."

In addition to the November 2000 guidance, on November 2, 2001 the OCC issued a 17-page bulletin to national banks to provide guidance on managing the risks arising from national banks' third-party relationships.[3] Although OCC Bulletin 2001-47 is not solely limited to payday lending activities through third parties, the directives and guidelines articulated in the bulletin clearly cover those relationships between national banks and third parties that are established to originate payday loans. Moreover, the financial press generally reported the announcement of OCC 2001-47 as the OCC's heightened scrutiny of national banks that partner with payday lenders to originate payday loans. The OCC's announcement of OCC 2001-47 quoted Comptroller of the Currency John D. Hawke, Jr. as stating, "National Banks should be extremely cautious before entering into any third-party relationship in which the third party offers products or services through the bank with fees, interest rates, or other terms that cannot be offered by the third party directly. Such arrangements may constitute an abuse of the national bank charter."

OCC 2001-47 directs national banks, as applicable, to adopt a risk management process that includes:

- a risk assessment to identify the bank's needs and requirements
- proper due diligence to identify and select a third-party provider
- written contracts that outline duties, obligations, and responsibilities of the parties involved
- ongoing oversight of the third parties and third-party activities

The bulletin articulates the various risks associated with third-party relationships including strategic risk, credit risk, compliance risk, reputation risk, and transaction risk. The bulletin also states that the OCC will scrutinize any arrangement and will likely conduct regular examinations of both the bank and the

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[2] See the OCC's November 27, 2000 press release *Agencies Urge Banks and Thrifts to Evaluate Risks with Vendors Engaged in Practices Viewed as Abusive to Customers* at <www.occ.treas.gov/00rellst.htm>.

[3] See the OCC's November 2, 2001 press release *OCC Guidance Cautions National Banks on Third-Party Relationships* at <www.occ.treas.gov/01rellst.htm>.

third party to assess the risks associated with activities conducted through third parties.

The Federal Reserve System continues to closely monitor payday lending and charter renting in the banking industry in general and at state member banks in particular. To provide clarification to the industry, on March 24, 2000 the Federal Reserve Board expanded the official staff commentary to Regulation Z to clarify that payday lending is a form of credit and that payday lenders are subject to the disclosure requirements of Regulation Z.[4] The guidance noted that the *Truth in Lending Act* and Regulation Z do not impair a state's authority to regulate or prohibit payday lending activities. However, creditors that regularly extend payday loans are required to provide disclosures to consumers consistent with the requirements of Regulation Z.

Recent Developments

On January 3, 2002, the OCC announced that Eagle National Bank (Eagle), a $70 million-asset bank based in Upper Darby, Pennsylvania, signed a Consent Order (Order) directing the bank to cease all payday lending activities.[5] Over the past several years, Eagle had originated payday loans in several different states through an exclusive arrangement with the Berwyn, Pennsylvania-based payday lender, Dollar Financial Group, Inc. (Dollar). Among other provisions in the Order, Eagle must limit outstanding payday loans on its books to no more than 100 percent of capital and adopt an exit strategy under which it will discontinue payday lending activities by June 15, 2002.

The OCC noted that the Order follows a recent examination in which examiners determined that Eagle relinquished supervision of the program to a single third-party originator. Comptroller Hawke stated, "Eagle had effectively turned over the management of the bank's main business to a third party, and then virtually ignored how that business was being conducted." Mr. Hawke further commented, "This case demonstrates the dangers inherent in arrangements under which national banks rent out their charters to nonbank providers of financial services. Not only did Eagle allow itself to become a mere appendage to Dollar, but it effectively collaborated in Dollar's scheme to evade state law requirements that would otherwise be applicable to it."

The next day, Standard and Poor's rating service revised its outlook on Dollar from stable to negative, based on increased regulatory scrutiny, the potential for litigation, and Dollar's poor tangible equity position.

Risks to Financial Institutions that Participate in Payday Lending

The November 2000 guidance issued by the OCC and the OTS and the November 2001 guidance issued by the OCC articulate the risks inherent in payday lending arrangements with third parties. Although this guidance was targeted to national banks and federal thrifts, state-chartered banks conducting payday lending activities also face the same risks.

Strategic Risk. Strategic risk is the risk to earnings or capital arising from adverse business decisions or improper implementation of those decisions. The choice of an institution to partner with a particular third party to originate payday loans may not be compatible with the overall strategic goals of the bank or may not provide an adequate return on investment. Likewise, strategic risk exists when an institution, in an effort to remain competitive or boost earnings, engages in payday lending activities through a third-party relationship without fully performing due diligence reviews or implementing the appropriate risk management infrastructure to oversee or monitor the payday lending activities of the third party.

Credit Risk. Credit risk is the risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the institution or otherwise to perform as agreed. Many borrowers who use payday loans have limited financial capacity or blemished or insufficient credit histories that limit their access to other forms of credit. Such circumstances, coupled with the unsecured nature of the loan, present significant credit risk. In many instances, payday loans can be considered as subprime credit. Credit risk further increases should the third party through which the payday loans are originated become unable or unwilling to meet the contractual terms of the arrangement.

Compliance and Legal Risks. Compliance and legal risks are the risks to earnings or capital arising from violations of laws, rules, or regulations or from nonconformance with internal policies and procedures or ethical stan-

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[4] See the Federal Reserve's final rule containing revisions to the official staff commentary to Regulation Z at < www.federalreserve.gov/boarddocs/press/boardacts/2000/20000324/attachment.pdf>.

[5] See the OCC's January 3, 2002 press release *OCC Orders Eagle to Cease Payday Lending Program* at <www.occ.treas.gov/02rellst.htm>.

dards. Payday loan transactions are subject to various federal and state consumer protection and fair lending laws. Institutions that originate or purchase payday loans must take special care to ensure compliance, as applicable, with relevant provisions of the *Equal Credit Opportunity Act*, the *Truth in Lending Act*, the *Fair Credit Reporting Act*, the *Fair Debt Collection Practices Act*, the *Electronic Funds Transfer Act*, and the *Federal Trade Commission Act*, as well as applicable provisions of state usury and deceptive practices legislation. Additionally, payday loans transacted through third parties are subject to the consumer privacy and customer record safekeeping provisions of the *Gramm-Leach-Bliley Act*.

Considerable potential exists for violations of the *Equal Credit Opportunity Act*. The comparatively high interest rates on payday loans combined with compensation incentives based on loan volume may foster the illegal steering of certain borrowers to high-cost payday loans. In addition, delivery mechanisms used by the third party could result in targeted exploitation of unsophisticated borrowers.

Reputation Risk. Reputation risk is the risk to earnings or capital arising from negative public opinion. As already discussed, the topic of payday lending is controversial. Consumerists and some legislators generally view payday lending as abusive. In third-party arrangements where lower-income persons are the primary users of payday loans, there is the potential for negative publicity, which could in turn cause loss of community support and business for an institution.

Transaction Risk. Transaction risk is the risk to earnings or capital arising from problems with service or product delivery. Payday loans are a specialized form of lending, typically not found in commercial banks or thrifts. Operational and transaction risks are often high, given the high volume of loans and the movement of loan documentation on the part of a third-party originator. Also, payday loans are largely underwritten off-site and employees or agents of third-party payday lenders are usually compensated based on the volumes of loans originated. Thus, there is the risk that third-party employees or agents may misrepresent information about the loans or fail to adhere to established underwriting criteria.

Final Thoughts

Payday lending has grown rapidly over the past decade, and consumerists, legislators, and regulators have voiced concerns over the impact that payday loans have upon some population segments. In addition, some legislators and regulators question the use of the federal preemption of the *National Bank Act* to enable banks and payday lenders to partner and offer payday loans in states where the origination of payday loans would otherwise be prohibited.

While some critics of payday loans would likely ban payday lending if they had their way, the phenomenal growth of payday loans suggests that the aggregate need underlying such products may be greater than previously thought. In view of such need, legislators and regulators will be challenged to participate in the formation of public policy that addresses the offering of such financial services while balancing the protections of consumers with the rights of entrepreneurs.

In the meantime, banks that partner with third parties to offer payday loans should carefully assess the fit of payday lending within their strategic plan, evaluate the risks inherent in payday lending, and implement procedures and practices to sufficiently address all risks, including compliance and legal risks.

If you have any questions on the risks of payday lending, please contact Robert Snarr (Robert.Snarr@phil.frb.org) at (215) 574-3460.

CRA Sunshine Examination Procedures Released

In December 2001, FFIEC approved interagency examination procedures that help examiners assess financial institutions' compliance with the CRA Sunshine Requirements provisions of the *Gramm-Leach-Bliley Act* (GLBA). The Federal Reserve System's Regulation G (12 CFR 207)[1], which became effective on April 1, 2001, implements the GLBA CRA Sunshine Requirements provisions.

Regulation G generally requires nongovernmental entities or persons and insured depository institutions or affiliates that are parties to certain written agreements made in fulfillment of the Community Reinvestment Act (CRA) to (i) make the agreements available to the public and to the relevant supervisory agency and (ii) file annual reports concerning those agreements with the relevant supervisory agency. In addition to describing factors related to the fulfillment of the CRA, Regulation G also provides criteria for determining when an agreement is a "covered agreement," thus triggering the disclosure and annual reporting requirements of the regulation.

The new examination procedures focus first on whether management is sufficiently familiar with the requirements of Regulation G to enable them to identify covered agreements. In the event that management has determined that the institution is a party to one or more covered agreements, the examination procedures then focus on the institution's practices regarding the disclosure of covered agreements and the filing of annual reports, as required by the regulation. Both of these reviews can be accomplished through a discussion with management or by reviewing the institution's policies and procedures regarding Regulation G.

The Board's March 2001 procedures for filing of documents related to the CRA Sunshine Requirements are available on the Board of Governor's web site at <www.federalreserve.gov/boarddocs/press/boardacts/2001/20010322/default.htm>.

The Consumer Compliance Handbook will soon be available on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/supmanual/>.

[1] See the joint final rule on *Disclosure and Reporting of CRA-Related Agreements* (the Board's Regulation G) at <www.federalreserve.gov/BoardDocs/Press/BoardActs/2000/200012214/Attachment.pdf>.

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