

Draft Guidelines For Payday Lending

Comments concerning these draft guidelines can be sent to: PaydayComments@fdic.gov.

The deadline for comments is 5:00 p.m. (ET), Friday, March 14, 2003.

Purpose

This guidance provides information about payday lending, a particular type of subprime lending, and supplements previously issued guidance about such programs.¹ It describes safety and soundness and compliance considerations for examining and supervising state nonmember institutions that have payday lending programs.

Background

In recent years a number of lenders have extended their risk selection standards to attract subprime loans. Among the various types of subprime loans, "payday loans" are now offered by an increasing number of insured depository institutions.

Payday loans (also known as deferred deposit advances) are small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck or regular income payment (such as a social security check). Payday loans are usually priced at a fixed dollar fee, which represents the finance charge to the borrower. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate (APR), is very high.²

In return for the loan, the borrower usually provides the lender with a check or debit authorization for the amount of the loan plus the fee. The check is either post-dated to the borrower's next payday or the lender agrees to defer presenting the check for payment until a future date, usually two weeks or less. When the loan is due, the lender expects to collect the loan by depositing the check or debiting the borrower's account or by having the borrower redeem the check with a cash payment. If the borrower informs the lender that he or she does not have the funds to repay the loan, the loan is often refinanced³ through payment of an additional fee. If the borrower does not redeem the check in cash and the loan is not refinanced, the lender normally puts the check or debit authorization through the payment system. If the borrower's deposit account has insufficient funds, the borrower typically incurs NSF charges on this account. If the check or the debit is returned to the lender unpaid, the lender also may impose a returned item fee plus collection charges on the loan.

Significant Risks

Borrowers who obtain payday loans generally have cash flow difficulties, and few, if any, lower-cost borrowing alternatives. In addition, payday lenders typically perform minimal analysis of the borrower's ability to repay either at the loan's inception or upon refinancing; they may merely require a current pay stub or proof of a regular income

source and evidence that the customer has a checking account. Some payday lenders also may consult nationwide databases that track bounced checks and persons with outstanding payday loans. The combination of the borrower's limited financial capacity, the unsecured nature of the credit, and the limited underwriting analysis of the borrower's ability to repay pose substantial credit risk for insured depository institutions.

Insured depository institutions may have payday lending programs that they administer directly, using their own employees, or they may enter into arrangements with third parties. In the latter arrangements, the institution typically enters into an agreement in which the institution funds payday loans originated through the third party. These arrangements also may involve the sale to the third party of the loans or servicing rights to the loans.⁴ Institutions also may rely on the third party to provide additional services that the bank would normally provide, including collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transaction, legal, and reputation risks.

Current law authorizes national and state-chartered insured depository institutions making loans to out of state borrowers to "export" favorable interest rates provided under the laws of the out of state lender's home state. That is, a state-chartered bank headquartered in a state with no usury limitations may make loans at any interest rate authorized by section 27 of the FDI Act to borrowers residing in another state, regardless of the other state's usury limits.⁵ Institutions face increased reputation risk when they enter into arrangements with third parties to offer payday loans with fees, interest rates, or terms that could not be offered by the third party directly.

Payday loans are a form of specialized lending not typically found in state nonmember institutions, and are most frequently originated by unregulated specialized nonbank firms. Payday loans can be subject to high levels of transaction risk given the large volume of loans, the handling of documents, and the movement of loan funds between the institution and any third party originators. Because payday loans may be underwritten off-site, there also is the risk that agents or employees may misrepresent information about the loans or increase credit risk by failing to adhere to established underwriting guidelines.

Procedures

Examiners should apply this guidance to banks with payday lending programs that the bank administers directly or that are administered by a third party contractor. This guidance does **not** apply to situations where a bank makes occasional small short-term loans to its customers.

As described in the *2001 Subprime Guidance*, a program involves the regular origination of loans, using tailored marketing, underwriting standards and risk selection. The *2001 Subprime Guidance* applies specifically to institutions with

programs where the aggregate credit exposure is equal to or greater than 25% or more of tier 1 capital. However, because of the significant credit, operational, legal, and reputation risks inherent in payday lending, this guidance applies regardless of whether a payday loan program meets that credit exposure threshold.

All examiners should use the procedures outlined in the *Subprime Lending Examination Procedures*, as well as those described here. While focused on safety and soundness issues, segments of the *Subprime Lending Examination Procedures* also are applicable to compliance examinations. They will need to be supplemented with existing procedures relating to specific consumer protection laws and regulations.

Concurrent examinations should be conducted where there are significant overlapping safety and soundness and compliance concerns. Concurrent examinations are not required in the absence of such circumstances. However, a review of each discipline's examinations and workpapers should be part of the pre-examination planning process. Relevant state examinations also should be reviewed.

When examiners determine that risk management practices are deficient, they should criticize management and initiate corrective action. Such actions may include formal or informal enforcement action. When risk management practices are seriously deficient, enforcement actions may instruct institutions to discontinue payday lending.

Safety and Soundness Issues

Capital Adequacy

The FDIC's minimum capital requirements generally apply to portfolios that exhibit substantially lower risk profiles and that are subject to more stringent underwriting procedures than exist in payday lending programs. Therefore, minimum capital requirements are not sufficient to offset the risks associated with payday lending.

As noted in the *2001 Subprime Guidance*, examiners should reasonably expect, as a starting point, that an institution would hold capital against subprime portfolios in an amount that is one and a half to three times greater than what is appropriate for non-subprime assets of a similar type. However, payday lending is among the highest risk subsets of subprime lending, and significantly higher levels of capital than the starting point should be required.

The *2001 Subprime Guidance* indicates that institutions that underwrite higher risk subprime pools, such as payday loans, need significantly higher levels of capital, perhaps as high as 100% of the loans outstanding (dollar-for-dollar capital), depending on the level and volatility of risk. Risks to consider when determining capital requirements include the unsecured nature of the credit, the relative levels of risk of default, loss in the event of default, and the level of classified assets. Examiners

should also consider the degree of legal and/or reputational risk associated with the payday business line, especially as it relates to third-party agreements.

Because of the higher inherent risk levels and the increased impact that payday lending portfolios may have on an institution's overall capital, examiners should document and reference each institution's capital evaluation in their comments and conclusions regarding capital adequacy. (Refer to the *2001 Subprime Guidance* for further information on capital expectations.)

Allowance for Loan and Lease Losses (ALLL) Adequacy

As with other segments of an institution's loan portfolio, examiners should ensure that institutions maintain an ALLL that is adequate to absorb estimated credit losses within the payday loan portfolio. Consistent with the *Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Associations (Interagency Policy Statement on ALLL)*,⁶ the term "estimated credit losses" means an estimate of the current amount of loans that is not likely to be collected; that is, net charge-offs that are likely to be realized in a segment of the loan portfolio given the facts and circumstances as of the evaluation date. Although the contractual term of each payday loan may be short, institutions' methodologies for estimating credit losses on these loans should take into account the fact that many payday loans remain continuously outstanding for longer periods because of renewals and rollovers. In addition, institutions should evaluate the collectibility of accrued fees and finance charges on payday loans and employ appropriate methods to ensure that income is accurately measured.

Examiners should ensure that institutions engaged in payday lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL for payday loans is appropriate. The application of historical loss rates to the payday loan portfolio, adjusted for the current environmental factors, is one way to determine the ALLL needed for these loans. Environmental factors include levels of and trends in delinquencies and charge-offs, trends in loan volume, effects of changes in risk selection and underwriting standards and in account management practices, and current economic conditions. For institutions that do not have loss experience of their own, it may be appropriate to reference the payday loan loss experience of other institutions with payday loan portfolios with similar attributes. Other methods, such as loss estimation models, are acceptable if they estimate losses in accordance with generally accepted accounting principles. Examiners should review documentation to ensure that institutions loss estimates and allowance methodologies are consistent with the *Interagency Policy Statement on ALLL*.

Classification Guidelines

The *Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy)*⁷ establishes general classification thresholds for consumer loans based on delinquency, but also grants examiners the discretion to classify individual

retail loans that exhibit signs of credit weakness regardless of delinquency status. An examiner also may classify retail portfolios, or segments thereof, *where underwriting standards are weak and present unreasonable credit risk*, and may criticize account management practices that are deficient.

Most payday loans have well-defined weaknesses that jeopardize the liquidation of the debt. Weaknesses include limited or no analysis of repayment capacity and the unsecured nature of the credit. In addition, payday loan portfolios are characterized by a marked proportion of obligors whose paying capacity is questionable. As a result of these weaknesses, payday loan portfolios should be classified Substandard. Furthermore, payday loans that have been outstanding for extended periods of time evidence a high risk of loss. While such loans may have some recovery value, it is not practical or desirable to defer writing off these essentially worthless assets. Payday loans that are outstanding for greater than 60 days from origination generally meet the definition of Loss. In certain circumstances, earlier charge off may be appropriate (i.e., the bank does not renew beyond the first payday and the borrower is unable to pay, the bank closes an account, etc.). When classifying payday loans, examiners should reference the *Retail Classification Policy* as the source document. Examiners would normally not classify loans for which the institution has documented adequate paying capacity of the obligors and/or sufficient collateral protection or credit enhancement.

Renewals/Rewrites

The *Retail Classification Policy* establishes guidelines for extensions, deferrals, renewals, or rewrites of closed-end accounts. Despite the short-term nature of payday loans, borrowers that request an extension, deferral, renewal, or rewrite should exhibit a renewed willingness and ability to repay the loan. Examiners should ensure that institutions adopt and adhere to the *Retail Classification Policy* standards that control the use of extensions, deferrals, renewals, or rewrites of payday loans. Under the *Retail Classification Policy*, institutions' standards should:

- Limit the number and frequency of extensions, deferrals, renewals, and rewrites;
- Prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer; and
- Ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained.

In addition to the above items, institutions should also:

- Establish appropriate "cooling off" or waiting periods between the time a payday loan is repaid and another application is made;
- Establish the maximum number of loans per customer that are allowed within one calendar year or other designated time period; and

- Provide that no more than one payday loan is outstanding with the bank at a time to any one borrower.

Accrued Fees and Finance Charges ⁸

Examiners should ensure that institutions evaluate the collectibility of accrued fees and finance charges on payday loans because a portion of accrued interest and fees is generally not collectible. Although regulatory reporting instructions do not require payday loans to be placed on nonaccrual based on delinquency status, institutions should employ appropriate methods to ensure that income is accurately measured. Such methods may include providing loss allowances for uncollectible fees and finance charges or placing delinquent and impaired receivables on nonaccrual status. After a loan is placed on nonaccrual status, subsequent fees and finance charges imposed on the borrower would not be recognized in income and accrued, but unpaid fees and finance charges normally would be reversed from income.

Recovery Practices

After a loan is charged off, institutions must properly report any subsequent collections on the loan.⁹ Typically, some or all of such collections are reported as recoveries to the ALLL. In some instances, the total amount credited to the ALLL as recoveries on an individual loan (which may have included principal, finance charges, and fees) may exceed the amount previously charged off against the ALLL on that loan (which may have been limited to principal). Such a practice understates an institution's net charge-off experience, which is an important indicator of the credit quality and performance of an institution's portfolio.

Consistent with regulatory reporting instructions and prevalent industry practice, recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, institutions must ensure that the total amount credited to the ALLL as recoveries on a loan (which may include amounts representing principal, finance charges, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of this limit should be recognized as income.

Third-Party Relationships and Agreements

Examiners should assess the institution's risk management program for third-party payday lending relationships. An assessment of third-party relationships should include an evaluation of the bank's risk assessment and strategic planning, as well as the bank's due diligence process for selecting a competent and qualified third party provider. (Refer to the *Subprime Lending Examination Procedures* for additional detail on strategic planning and due diligence.)

Examiners also should ensure that arrangements with third parties are guided by written contract and approved by the institution's board. At a minimum, the arrangement should:

- Describe the duties and responsibilities of each party, including the scope of the arrangement, performance measures or benchmarks, and responsibilities for providing and receiving information;
- Specify that the third party will comply with all applicable laws and regulations;
- Specify which party will provide consumer compliance related disclosures;
- Authorize the institution to monitor the third party and periodically review and verify that the third party and its representatives are complying with its agreement with the institution;
- Authorize the institution and the appropriate banking agency to have access to such records of the third party and conduct onsite transaction testing and operational reviews at third party locations as necessary or appropriate to evaluate such compliance;
- Require the third party to indemnify the institution for potential liability resulting from action of the third party with regard to the payday lending program; and
- Address customer complaints, including any responsibility for third-party forwarding and responding to such complaints.

Examiners also should ensure that management sufficiently monitors the third party with respect to its activities and performance. Management should dedicate sufficient staff with the necessary expertise to oversee the third party. The bank's oversight program should monitor the third party's financial condition, its controls, and the quality of its service and support. Oversight programs should be documented sufficiently to facilitate the monitoring and management of the risks associated with third-party relationships.

Compliance Issues

Payday lending raises many consumer protection issues and attracts a great deal of attention from consumer advocates and other regulatory organizations, increasing the potential for litigation. Laws and regulations to be closely scrutinized when reviewing payday lending during consumer compliance examinations include:

Equal Credit Opportunity Act/ Regulation B

Illegal discrimination may occur when a bank has both payday and other short-term lending programs that feature substantially different interest rate or pricing structures. Examiners should determine to whom the products are marketed, and how the rates or fees for each program are set, and whether there is evidence of potential discrimination. Payday lending, like other forms of lending, is also susceptible to discriminatory practices such as discouraging applications, requesting information or evaluating applications on a prohibited basis. If the lender requires that a borrower have income from a job, and does not consider income from other sources such as

social security or veterans benefits, then it is illegally discriminating against applicants whose income derives from public assistance.

ECOA and Regulation B limit the type of information that may be requested of applicants during an application for credit. A creditor may not refuse to grant an individual account to a creditworthy applicant on the basis of sex, marital status or any other prohibited basis. A state nonmember bank must ensure that its payday lending program complies with these limitations.

ECOA and Regulation B require creditors to notify applicants of actions taken in connection with an application for credit. Notices of action taken must be provided within specified time frames and in specified forms. State nonmember banks involved in payday lending must ensure that such notices are given in an accurate and timely manner.

Truth in Lending Act/ Regulation Z

TILA and Regulation Z¹⁰ require banks engaged in consumer lending to ensure that accurate disclosures are provided to customers. A bank that fails to disclose finance charges and APRs accurately for payday loans - considering the small dollar tolerance for inaccuracies - risks having to pay restitution to consumers, which in some instances could be substantial. This risk remains even if the bank provides loans through a third-party agreement.

TILA and Regulation Z also require banks to advertise their loan products in accordance with their provisions. For example, advertisements that state specific credit terms may state only those terms that actually are or will be arranged or offered by the creditor. If an advertisement states a rate of finance charge, it must state the rate as an APR, using that term. If the APR may be increased after consummation the advertisement must so state. Additional disclosures also may be required in the advertisements.

Fair Credit Reporting Act

A bank engaged directly or indirectly in payday lending is responsible for complying with requirements to provide notice to a consumer when it declines an application for credit or takes other adverse action based on certain information. If adverse action is taken based on information received from a consumer reporting agency, the consumer must be notified and provided the name and address of the consumer reporting agency. It is important to note that information in "bad check lists" or databases that track outstanding payday loans are considered to be consumer reports, and therefore the companies that provide such a tracking service (such as Teletrack) are consumer reporting agencies. If adverse action is taken based on information received from a third party that is not a consumer reporting agency, the adverse action notice must direct the consumer to the bank, and not any third party, for details regarding the

character of the information (even where the payday loan applications are received by the bank through a third party such as a payday lender).

Electronic Fund Transfer Act (EFTA)/ Regulation E and Truth in Savings Act (TISA)

Payday lending arrangements that involve the opening of a deposit account or the establishment of "electronic fund transfers" must meet the disclosure and other requirements of both the EFTA and TISA. Examples include providing a device to access funds from a deposit account, or depositing a payday loan directly in a borrower's account and debiting the subsequent payment.

Fair Debt Collection Practices Act (FDCPA)

If a bank engages in payday lending through an arrangement with a third party, and the third party collects defaulted debts on behalf of the bank, the third party may become subject to the provisions of the FDCPA. Although the bank itself may not be subject to the FDCPA, it may face reputational risk if the third party violates the FDCPA in collecting the bank's loans. A compliance program should provide for monitoring of collection activities, including collection calls, of any third party on behalf of the bank.

Federal Trade Commission Act (FTC Act)

The Federal Trade Commission Act (FTC Act) declares that unfair or deceptive trade practices are illegal. (See 15 USC § 45(a)). State nonmember banks and their institution-affiliated parties will be cited for violations of section 5 of the FTC Act and the FDIC will take appropriate action pursuant to its authority under section 8 of the Federal Deposit Insurance Act when unfair or deceptive trade practices are discovered. Examiners should focus attention on marketing programs for payday loans, and also be alert for potentially abusive collection practices. Of particular concern is the practice of threatening, and in some cases pursuing, criminal bad check charges, despite the payment of offsetting fees by the consumer and the lender's knowledge at the time the check was accepted that there were insufficient funds to pay it. If evidence of unfair or deceptive trade practices is found, examiners should consult with the regional office and the region should consult with Washington.

FDIC enforcement action against entities other than banks that engage in unfair or deceptive trade practices will be coordinated with the Federal Trade Commission. (Refer to FIL-57-2002, dated May 30, 2002, for further information.)

Community Reinvestment Act (CRA)/ Part 345

Payday lending can negatively impact a bank's CRA performance. An evaluation of CRA lending, particularly within assessment areas, should consider relevant performance context factors, as well as evidence of discrimination or other illegal credit practices. Examiners should note in the CRA public evaluation the fact that a

state nonmember bank is involved with a payday lending program, regardless of whether it negatively impacts the rating. A bank's development of loan programs that provide small, unsecured loans with reasonable terms commensurate with a borrower's ability to repay could positively impact CRA performance. Programs that include a financial education component about how to avoid abusive or unsuitable loans receive favorable treatment under CRA as well.

Privacy of Consumer Financial Information/Part 332

Payday lending arrangements are subject to the same financial privacy information sharing restrictions and requirements as any other type of consumer product. The bank should ensure consumers are appropriately provided with a copy of the bank's initial, revised, and annual notices, as applicable. In addition, the bank should ensure that a consumer's nonpublic personal information is used and disclosed only as permitted and described in the privacy notice.

Safeguarding Customer Information

The Interagency Guidelines Establishing Standards for Safeguarding Customer Information, Appendix B to Part 364, require banks to implement a written information security program to protect the security, confidentiality, and integrity of customer information. The guidelines require banks to assess reasonably foreseeable internal and external threats that could result in unauthorized uses or destruction of customer information systems, and to design a security program to control those risks. A bank's board of directors should approve the written program and oversee its implementation.

Examiners should ensure the bank has appropriately addressed the security risks in payday lending arrangements to safeguard customer information, whether in paper, electronic, or other form, maintained by or on behalf of the bank.

¹ See January 31, 2001, interagency *Expanded Guidance for Subprime Lending Programs* (FIL 9-2001) (2001 Subprime Guidance); January 24, 2000, *Subprime Lending Examination Procedures* (RD Memo No. 00-004); March 4, 1999, *Interagency Guidelines on Subprime Lending* (FIL-20-99); and May 2, 1997, *Risks Associated with Subprime Lending* (FIL-44-97).

² The typical charge is \$15 to \$20 per \$100 advanced for a two-week period, resulting in an APR of nearly 400%.

³ Payday lenders generally use the term "rollover." Other terms used may include extension, deferral, renewal or rewrite.

⁴ Insured depository institutions also may fund payday lenders through a lending relationship. This guidance does not address such situations.

⁵ See section 27 of the Federal Deposit Insurance Act, 12 U.S.C. § 1831d (enacted as section 521 of the Depository Institutions Deregulation and Monetary Control Act of 1980 [the "DIDMCA"]). The authority of national banks to export favorable interest rates on loans to borrowers residing in other states was recognized by the U.S. Supreme Court in *Marquette National Bank of Minneapolis v. First Omaha Service Corp.*, 439 U.S. 299 (1978), in the context of section 85 of the National Bank Act. That authority was subsequently extended to credit unions, savings associations, state nonmember banks and insured foreign branches in the DIDMCA to provide competitive lending equality with national banks.

⁶ See July 25, 2001, *Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Associations* (FIL 63-2001).

⁷ See June 29, 2000, *Uniform Retail Credit Classification and Account Management Policy* (FIL -40-2000).

⁸ AICPA Statement of Position 01-6 *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, provides guidance for accounting for delinquency fees.

⁹ AICPA Statement of Position 01-6 provides recognition guidance for recoveries of previously charged-off loans.

¹⁰ Federal Reserve Board staff considered payday loans in the context of Regulation Z, and found that they are a form of credit under the Truth in Lending Act, and that the fees are finance charges that must be disclosed as an APR, regardless of how the fee is characterized under state law. 12 CFR Part 226, Supplement I, Subpart A, Section 226.2(a)(14), note 2.