Remarks
of
FDIC Director
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Women in Housing and Finance
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Thank you.

This afternoon I would like to talk about an issue of great concern to me as a former state bank regulator from Massachusetts and in my current role at the FDIC. That issue is payday lending.

Some background on payday lending probably is in order. The FDIC has defined payday loans as "…small-dollar, short-term, unsecured loans that borrowers promise to repay out of their next paycheck …. 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." APRs on these loans can be 400% or higher. Little if any credit analysis is performed. Payday loans are not generally underwritten on the basis of the borrower's ability to repay. Evidence of employment or regular source of income and a checking account are all that is required. The typical borrower has cash flow difficulties and has limited, if any, lower-cost alternatives. (FDIC Guidelines for Payday Lending, July, 2003). Recent state-generated data suggests that borrowers repeatedly "rollover" these loans. Borrowers in these states average 8 to 13 or more payday loans suggesting that payday loans frequently are a source of recurring rather than short-term debt.

Today, I would like to express my personal views on some of the regulatory policy issues raised by this subject.

I am a firm believer in full disclosure and transparency whether it is in financial reporting or in public policy. Consequently, a few disclaimers are in order. As you may know, I am a product of the dual banking system, having spent most of my professional career at the Massachusetts Division of Banks. As Massachusetts Bank Commissioner, I had a "bird's eye" view of the local emergence of fringe banking products and services such as check cashers and payday lenders in the early 1990s. My views on payday lending are my own and they reflect the questionable impact that these fringe financial products have had on debt-laden individuals and families.

As a local public official, I grappled with the issue of how payday lending activities meshed with the Massachusetts Small Loan Act, a 100 year old civil and criminal statute from the "Progressive Era" designed to combat abusive consumer lending by

small loan lenders and loan brokers. The Commonwealth's response was clear and simple. Payday lenders were either de facto small loan lenders or brokers, regardless of any bank partnership arrangement. As such they were subject to the Act's licensing and other substantive provisions. There was zero tolerance for Small Loan Act violators who faced the certain prospect of administrative as well as civil and criminal sanctions.

Common sense is a necessary attribute for any state or federal bank regulator. Setting the appropriate regulatory tone on supervisory issues is also critical. We can easily trip ourselves up if we become too absorbed in the details of an artfully crafted arrangement so that we fail to see the underlying substance of a transaction. It is the common error of elevating form over substance.

In essence, this was the risk management disaster for those institutions that engaged in Enron-related complex structured finance transactions. In isolation, these transactions appeared perfectly legitimate. 20/20 hindsight, however, clearly reveals that they entailed substantial reputational and legal risk when the customer used the complex structured finance transaction to circumvent regulatory or financial reporting requirements, evade tax liabilities or to further other illegal or improper behavior.

It is my personal view that some of the partnership arrangements between state nonmember banks and payday lenders fall into this same general category. These partnerships, which yield significant fee income for participating banks, have marginal, if any, direct bank involvement. One could conclude that these partnerships serve only to provide a vehicle to evade state usury and licensing laws that would otherwise prevent the payday lender from directly operating in that jurisdiction. In effect, these third-party arrangements appear to have been created for no real purpose other than to mask the payday lender's underlying role in these transactions.

Today, we have the widespread expansion of payday lending activities under third-party arrangements. The number of FDIC-supervised, state nonmember banks involved in these arrangements has grown from a few banks to 11 institutions. Moreover, payday lending has expanded into 14 states that would otherwise ban or limit this high-rate product. I am deeply disturbed by this trend as a former state bank regulator and as a FDIC Board member. My personal view is that the FDIC has a unique opportunity to reexamine and revise its stance on payday lending now after almost 15 months experience under its July 2003 Guidelines for Payday Lending. Whether or not the FDIC revises the Guidelines, we should reiterate that both the letter and spirit of the FDIC Guidelines will be vigorously enforced against those institutions who continue to underestimate the inherent reputational and legal risks associated with third-party payday lending arrangements.

Many observers who have misgivings about the suitability of payday lending as a form of consumer credit, have thrown up their hands after concluding that third-party payday lending is a legal activity under a theory of federal preemption. I tend to question this conclusion. Despite my provincial background, I have read the U. S. Constitution and I am aware that it contains something called the "Supremacy Clause." I also believe that

federal law deregulating the interest rates that national banks and federally insured state banks may charge has generally benefited consumers of traditional banking products.

It should be noted that payday lenders are not highly regulated banks subject to supervision by federal bank regulatory agencies. The public policy rationale for deregulating interest rates for banks does not necessarily extend to fringe banking services providers. Ordinarily, federal law does not preempt state usury restrictions on nonbank lenders or their products.

There is little doubt that state laws restricting direct payday lending by out of state federally insured depository institutions would be preempted by the interest rate exportation provisions of the National Bank Act and the Depository Institutions Deregulation and Monetary Control Act of 1980. The real argument centers on whether nonbank payday lenders enjoy the same preemptive authority when they "partner" with FDIC-insured institutions for indirect payday lending. This type of activity has been justified under the legal theory that the third-party agent of a bank enjoys the same preemptive powers of a bank under federal law. This very well may or may not be true.

This question, however, necessarily requires a preliminary determination as to whether there is a bona fide agency relationship between a payday lender and the FDIC-insured bank. If it is a sham relationship or transaction, the issue as to whether there is federal preemption of state usury laws need not even be reached. Essentially, the issue is one of fact as much as law. State and federal regulators should not be quick to assume or presume that all third-party arrangements by banks are genuine. It is a relevant legal and examination line of inquiry for regulators to critically test this type of assertion especially where important local state interests such as protecting against predatory consumer lending practices are at stake.

In my view, it is difficult to conclude that a bona fide third-party agency relationship exists between many state nonmember banks and payday lenders where the predominate economic interest in, and control over, these programs remains with the payday lender. This conclusion is underscored where it is the bank's policy not to directly or indirectly make high-rate, short-term payday loans in its own market for CRA and reputational considerations. Extensive day-to-day control over marketing, loan underwriting, loan administration and collections by the payday lender also tend to negate a finding of a true agency relationship. If this type of artificially structured arrangement is found to exist, federal and state regulators should label it the sham that it is. Alternatively, the very substantial legal and reputational risks associated with this unique type of third-party arrangement should be a formidable deterrent to any state nonmember bank thinking of engaging in this activity.

From a policy standpoint, mainstream banks should be very concerned by these third-party payday lending arrangements. This type of activity will inevitably invite a broader re-examination of other legitimate third-party agency relationships entered into by banks and even of federal preemption itself. Many of these bona fide third-party arrangements

have proven to be useful to banks entering into new areas or seeking to improve or expand their distribution channels. Legitimate third-party arrangements should not be placed at legislative or regulatory risk because of its inappropriate use in the payday lending context. It is my belief that this type of unwarranted scrutiny can be avoided through the FDIC's ongoing aggressive enforcement of the existing Guidelines on Payday Lending, and any subsequent amendments that may occur.

The FDIC Guidelines appropriately reference the applicability of certain laws to payday lending arrangements. In my view, both the industry and consumers would benefit from a clarification of which state laws apply to payday lending transactions. A clear statement on the applicability of state licensing laws governing nonbank payday lenders and brokers would be helpful. Clarification would be particularly useful where the payday lender is the de facto lender due to its predominate economic interest in a transaction. It would also preserve the states' ability to enforce their laws governing the conduct and activities of payday lenders and brokers.

I am pleased that the FDIC Guidelines specifically cite the Federal Trade Commission Act as a law or regulation governing the payday lending activities of state nonmember banks. The FDIC's March 2004 formal policy of making violations of Section 5 of the FTC Act a basis for taking appropriate action under the enforcement provisions of Section 8 of the FDI Act provides a potent compliance tool if abusive practices are detected.

Section 5 of the Federal Trade Commission Act presents a potential host of unexplored regulatory compliance issues. In my view, an appropriate area for further examination inquiry is whether state nonmember bank affiliate payday lending programs are engaging in a pattern or practice of making extensive payday loan rollovers or consecutive advances to borrowers without any demonstrated ability to repay. If so, is this a form of predatory consumer lending? In other words, are repeated payday loan "rollovers" roughly analogous to loan "flipping" in the predatory mortgage loan context? A related question is whether these effectively longer-term products are being deceptively marketed as a short-term credit product. The long-stated policy justification for payday lending has been that these loans' high interest rates are not oppressive because the loans are of short duration and not intended to be longer-term financing. It appears that payday lending statistics on rollovers compiled by consumer groups belie this argument. In any event, the FDIC's continued vigorous enforcement of the Guidelines will help ensure that state nonmember bank's third-party payday loan arrangements are in full compliance with Section 5 of the Federal Trade Commission Act.

In closing, I want to underscore the potentially abusive impact of chronic payday loan borrowing on debt laden individuals and their families. Its impact on military personnel is particularly troubling during times of hostilities abroad. I doubt anyone believes that payday lending is a suitable long-term consumer credit product. It is an issue that cries out for a better solution. My personal hope is that bankers can harness their proven creativity and deep community commitment to find "a better way." I have confidence

that the banking industry can develop a less-costly market-based alternative to payday loans just as it developed foreign remittance programs to compete with high price money services organizations.

Finally, I want to commend the leadership displayed by our FDIC Chairman Don Powell in championing the cause of financial literacy. Award-winning programs like the FDIC's MoneySmart Program will help eradicate the financial illiteracy that makes costly or unsuitable consumer loan products possible. Education is the ultimate weapon. Until these lofty financial literacy goals are achieved, regulators need to remain vigilant.

Thank you. I would be happy to take questions if time permits.

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