Consumer Federation of America

March 14, 2003

Via electronic mail to PaydayComments@fdic.gov

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429-9990

RE: Draft FDIC Guidelines for Payday Lending

Dear Sirs:

Consumer Federation of America files these revised comments regarding the Federal Deposit Insurance Corporation's Draft Guidelines for Payday Lending. Other organizations joining CFA in these comments include the Community Reinvestment Association of North Carolina, Consumers Union, U. S. Public Interest Research Group, National Community Reinvestment Coalition, National Consumer Law Center on behalf of its low-income clients, National Association of Consumer Advocates, the Neighborhood Economic Development Advocacy Project (NY), Legal Aid Society of Texas, Monsignor John Egan Campaign for Payday Loan Reform (IL), Economic Justice Institute (WI), Maryland Consumer Rights Coalition, Inc., Florida Public Interest Research Group, Michigan Consumer Federation, North Carolina Public Interest Research Group, and the Foreclosure Prevention Project at South Brooklyn Legal Services (NY).

We appreciate the FDIC's attention to the role of FDIC-insured nonmember banks in the payday loan market evidenced by issuing draft payday loan compliance guidelines. The Office of Thrift Supervision and the Comptroller of the Currency issued similar advisories to banks under their supervision. We urge the FDIC to go further than the draft guidelines to categorically prohibit FDIC-insured nonmember banks from renting their charters to third party payday lenders. State banks are now the partners of choice for payday lenders intending to make loans that violate state consumer protections and usury caps. A strong set of guidelines and vigorous enforcement will protect vulnerable consumers, safeguard the federal insurance program, and ensure a consistent regulatory environment for small lenders at the state level. If you have any questions, please call me at 757-867-7523.

Sincerely,

Jean Ann Fox, Director of Consumer Protection
Consumer Federation of America
1424 16th Street NW Suite 604 Washington, DC 20036

Comments

FDIC Draft Guidelines for Payday Lending

March 14, 2003

Comments submitted by Consumer Federation of America[1], Consumers Union, Community Reinvestment Association of North Carolina, U. S. Public Interest Research Group, National Consumer Law Center, the Foreclosure Prevention Project at South Brooklyn Legal Services (NY), National Community Reinvestment Coalition, Neighborhood Economic Development Advocacy Project, Legal Aid Society of Texas, Monsignor John Egan Campaign for Payday Loan Reform (IL), Economic Justice Institute (WI), Maryland Consumer Rights Coalition, Inc., Florida Public Interest Research Group, Michigan Consumer Federation, North Carolina Public Interest Research Group, and the National Association of Consumer Advocates to the Federal Deposit Insurance Corporation concerning draft guidelines for nonmember banks that engage directly or through third parties in the payday loan market.

We strongly urge the Federal Deposit Insurance Corporation to amend its draft guidelines for payday lending to:

- Definitively prohibit rent-a-bank payday lending by banks, particularly in situations where the third party originates the product and uses the bank as a delivery vehicle, and the third party retains the preponderant economic interest in the loans.
- Clearly state that third parties cannot "rent" bank powers to export interest rates or preempt state laws.
- Strengthen guidelines for direct bank "payday lending" to require any small loan product to be based on the borrower's ability to repay and have adequate terms to repay without flipping loans. Base bank Community Reinvestment Act evaluations on small loans made outside the bank's assessment area as well as within it.
- Conduct compliance inspections at all nonmember banks that currently partner with third parties to make payday loans and vigorously enforce guidelines and laws.

Role of Banks in Payday Lending

Payday loans are short-term cash loans made to consumers based on personal checks held for future deposit. These single-payment loans cost an average 470% annual interest rate and have a term of a few days to two weeks. The combination of check-holding, high interest rates, and unaffordable repayment sums results in outrageously expensive loans that trap cash-strapped consumers in perpetual debt, exposed to coercive collection tactics.

Payday lending involves inherently unsafe and unsound banking practices. Borrowers are enticed to solve their short-term cash needs by writing checks without money in the bank to

[1] Consumer Federation of America is a pro-consumer association of about three hundred non-profit organizations formed in 1968 to advance consumer interests through research, advocacy and education.

cover them. Loans are made without regard for the borrower's ability to repay. Conventional credit checks are not performed. Borrowers are not asked about other financial obligations. One of the grounds cited by the Comptroller for finding that First National Bank in Brookings used unsafe and unsound banking practices in its partnership with payday lenders was the "failure to identify the source of repayment and to assess the borrower's ability to repay the loan, in connection with short-term consumer loans originated in the name of or on behalf of the Bank."[2] We believe it is unconscionable to lend money to consumers without regard to whether the borrower can repay the loan.

We know of no banks that directly make payday loans to non-depositors. The role of banks is as partner with non-bank entities to make payday loans through what the former FDIC Chairman termed "rent-a-bank" arrangements. Typically the payday lender (pawn shop, check casher, retailer) solicits borrowers, takes loan applications, disburses loan proceeds, deals directly with customers, collects payments, and buys back 90 to 95% of the loan immediately from the bank. The bank essentially rents its charter to enable the third party to claim that bank powers to export home state interest rates apply to loans that would otherwise violate state usury, small loan, and, even, state payday loan laws.

Currently twenty-nine states and the District of Columbia authorize payday lending by licensed lenders, with varying levels of fee caps and restrictions. Another four states have no usury or small loan cap and do not otherwise regulate payday loan terms. Seventeen states retain their small loan laws and usury limits. Payday lenders partner with banks to make loans in states where usury laws prohibit direct lending at triple-digit interest rates and in states that authorize payday lending with restrictions. The rent-a-bank arrangement undercuts the authority of state credit regulators to enforce laws that apply to the small loan market, creating a consumer protection vacuum.

FDIC Joins OTS and OCC in Issuing Bank Guidance on Payday Lending

In January 2003 the Federal Deposit Insurance Corporation issued draft guidelines for payday lending that describe safety and soundness and compliance considerations for examining and supervising state nonmember institutions that have payday lending programs. The draft guidelines include application of federal credit laws to payday loans.

In 2000 the Office of Thrift Supervision and the Comptroller of the Currency issued Bank Advisories to federally-chartered financial institutions engaged in or considering payday lending arrangements. The OCC Bank Advisory, in addition to listing the federal laws that apply to payday loans, made a clear and important statement: "Payday lenders entering into such arrangements with national banks should not assume that the benefits of a bank charter, particularly with respect to the application of state and local law, would be available to them."[3] The FDIC draft guidelines do not include this clear statement against rent-a-bank arrangements and do not appear to benefit from the OCC and OTS experience in implementing their guidelines.

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[2] Consent Order, 2003-1, In the Matter of: First National Bank in Brookings, Comptroller of the Currency, p. 1
[3] OCC Advisory Letter AL 2000-10, p. 1.

We are disappointed that the guidelines do not directly deal with rent-a-bank arrangements. A letter last year from FDIC Chairman Powell to Consumer Federation of America stated: "However, the use of an insured depository institution's authority by non-bank lenders to make loans that would be prohibited or restricted in the borrower's state, absent the institution's involvement in the transaction, exposes the insured depository institution to business, legal, and reputational risks. In addition, these non-bank lenders should not assume that the same benefits provided to a bank when it makes a loan will be available to them, particularly with respect to the application of state and local law."[4]

We strongly urge the FDIC to amend the draft guidelines to include this statement concerning third parties and to include a list of rent-a-bank characteristics. These characteristics include a loan program developed by the non-bank entity that seeks to use the bank as a delivery vehicle and where the non-bank entity rather than the bank has the preponderant economic interest in the loan.

FDIC-Insured Nonmember Banks Targeted by Payday Lenders

In the last year, the OCC has signed Consent Orders halting all payday lending activity by federally-chartered banks with third parties. These actions applied to Eagle National Bank which partnered with Dollar Financial Group check cashers; Goleta National Bank that made loans through ACE Cash Express outlets; Peoples National Bank of Paris, TX that made payday loans with Advance America; and First National Bank in Brookings, SD that loaned through Cash America pawn shops and First American Cash Advance.

The Office of Thrift Supervision recently directed First Place Bank in Warren, Ohio to terminate its payday loan arrangements in Texas with Check'n Go. Earlier, the OTS downgraded the Community Reinvestment Act rating for Crusader Bank, a Philadelphia thrift that partnered with National Cash Advance in Pennsylvania and Delaware. When the First Place Bank arrangement is terminated, there will be no federal thrifts renting their charters to payday lenders to our knowledge.

In 2002 the Illinois Banking regulator and the FDIC took action against Brickyard Bank, a state nonmember bank renting its charter to Check'n Go in Texas and North Carolina. Following a public campaign by community and consumer groups and regulator-required higher capitalization requirements, the bank withdrew from the payday loan business.

Now that no federally-chartered financial institutions can partner with payday lenders, the industry is turning to state-chartered nonmember banks. According to a Cash America press release, "Based on current attitudes of federal regulators toward short term cash advances, we believe state chartered banks provide our customers with the most reliable source of future cash advances…"[5] An *American Banker* article noted that "Given the recent actions by the OCC and OTS, payday-lending companies say they will seek partnerships with state-chartered banks.

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[4] Letter from Donald E. Powell, Chairman, FDIC to Jean Ann Fox, Consumer Federation of America, June 19, 2002, on file with CFA.
[5] Press release, Cash America, "Cash America Announces Intention to Change Cash Advance Provider and Confirms Earnings for the Fourth Quarter of 2002," January 21, 2003.

They say the Federal Deposit Insurance Corp., which regulates state-chartered banks, is more permissive of the partnerships than other regulators."[6]

The payday loan industry has interpreted the draft guidelines as recognizing a place for third-party relationships.[7] The FDIC draft guidelines note that banks may have payday lending programs that they administer directly using their own employees or may enter into arrangements with third parties. "With third parties, the bank funds loans originated through a third party and may involve selling loans or servicing rights to the loans to a third party. The third party may handle collections, advertising and soliciting applications. The existence of third party arrangements may, when not properly managed, significantly increase institutions' transactions, legal and reputation risks."[8]

The largest, and, presumably most sophisticated, payday lenders in the country were partners with national banks and thrifts now ordered by their regulators to halt payday loan arrangements. There is no reason to believe that these same lenders will safely conduct payday loan operations through state-chartered nonmember banks.

State Chartered Nonmember Banks Currently Making Payday Loans

Although this list of state banks in the rent-a-bank payday loan business is not exhaustive, it illustrates the types of loan arrangements the FDIC currently permits.

- County Bank of Rehoboth Beach, DE is the most active state nonmember bank in the payday loan market. County Bank partners with third-party storefronts, such as Money Mart in Virginia and Oklahoma; Check'n Go, Express Money Service, and Urgent Money Service in North Carolina; Currency One in Philadelphia; USA Payday in Georgia; and EZ Pawn and Cash America in Oklahoma. County Bank also makes loans through third-party servicing agents that market loans via 800 numbers and Internet web sites.

- BankWest, Inc., Pierre, SD, partners with Advance America to make payday loans in Georgia. The Georgia Attorney General issued an opinion in 2002 that payday lending violates the Georgia Industrial Loan Act small loan rate caps. BankWest and Advance America brought legal action to prevent the state from investigating its payday lending in Georgia. The Superior Court of Fulton County dismissed the declaratory judgment action brought by Advance America and BankWest, Inc.

- Republic Bank and Trust Company is listed by Check Into Cash as making payday loans at a few outlets in North Carolina. This Kentucky bank also partners with Advance America in Texas.

- First Community Bank of Washington partners with Advance America and National Cash Advance to make payday loans in Alabama and Arkansas, two states with payday lender-unfriendly state law.

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[6] "OCC Payday Purge Done: Lenders Eye State Banks," American Banker, February 3, 2003, p. 2.
[7] Id.
[8] FDIC Draft Guidelines, Significant Risk section, page 1.

- First South Bank in Spartanburg, SC makes payday loans through FlexCheck, a chain of payday lenders operating in Virginia, Pennsylvania, and Georgia. Virginia law prohibits brokering of payday loans, while payday lending is not authorized in Pennsylvania or Georgia.

- First Fidelity Bank in Burke, South Dakota is used by Advance America to make payday loans in Michigan.

To make the state bank list complete, there is one Federal Reserve member state bank involved in payday lending. First Bank of Delaware partners with Check Into Cash to make loans in Georgia and in North Carolina, a state that terminated its experiment with payday lending over a year ago.

FDIC Should Prohibit Payday Lending by Nonmember Banks

The draft guidelines describe payday lending as inherently unsafe and unsound. Coupled with the compliance experience of the OCC and the OTS, the FDIC should conclude that no state-chartered nonmember bank can safely enter into payday lending through third parties. Descriptions about the unsavory features and risks of payday lending from the FDIC draft guidelines:

- "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 of risk."[9] A loan product that justifies dollar for dollar capitalization is too risky for both borrowers and banks to condone. The guidelines call for examiners to consider the unsecured nature of the credit, relative levels of risk of default, loss in the event of default, and level of classified assets. They must also consider the degree of legal and/or reputational risk associated with the payday business line, especially as it relates to third-party agreements.

- "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."[10] With this level of risk recognized by the FDIC, why should any nonmember bank be permitted to make these loans?

- "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

[9] FDIC Draft Guidelines, Capital Adequacy section, p. 3.
[10] FDIC Draft Guidelines, Procedures section, p. 2.

loan portfolios should be classified Substandard."[11] The agency responsible for safeguarding the publicly-backed deposit insurance fund should not condone banks making substandard loans that borrowers cannot afford.

- "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 can 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."[12] The Comptroller found a wide range of potential law violations when examining national banks engaged in payday lending, including violations of Truth in Lending and the Gramm-Leach-Bliley Act, and loss of control of the payday loan program by banks.

- "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."[13] Loans based on check-holding are inherently coercive.

Other Provisions of Guidelines Should be Strengthened

In addition to clearly prohibiting rent-a-bank payday lending, the FDIC draft guidelines should be strengthened in the areas of renewals and in CRA evaluation.

Renewals/Rewrites: The guidelines instruct that third party lenders asking for a renewal of a loan, should show a renewed willingness and ability to repay the loan and limit the number and frequency of extensions, deferrals, renewals and rewrites. But there is no requirement that borrowers must demonstrate ability to pay the original loans. Banks are urged to prohibit additional advances to finance unpaid interest and fees and simultaneous loans to the same customer. The draft calls on staff to ensure that comprehensive and effective risk management, reporting, and internal controls are established and maintained. Banks are to establish cooling off or waiting periods between the time the loan is repaid and another application made. Banks are expected to set a maximum number of loans per customer in one year or other time period. The draft sets a guideline of no more than one payday loan outstanding with the bank at a time to any one borrower.

This guidance does not require lenders to verify that borrowers have no other debts with other payday lenders. It also makes rollovers legitimate by encouraging a specific number. This guidance only treats the symptom of predatory payday lending without dealing with the root causes. Setting limits on loan flipping and multiple payday loans does not solve the problem of loans that are made: (1) without regard for the borrower's ability to afford or repay them, (2) that are too large to be repaid in a single balloon payment due in just days, (3) that cost too much to

[11] FDIC Draft Guidelines, Classification Guidelines section, p. 4.
[12] FDIC Draft Guidelines, Significant Risks section, p. 2.
[13] FDIC Draft Guidelines, Federal Trade Commission Act section, p. 7.

be repaid in one payment while meeting the borrower's other commitments, and (4) that coerce repayment or flipping because the lender holds the borrower's personal check.

CRA: The guidelines note that payday lending can negatively impact a bank's Community Reinvestment Act performance and call for examiners to note if the bank is involved in payday lending in the public record. The draft guidelines call for only payday lending within the bank's assessment area to be noted. CFA urges the FDIC to expand the CRA evaluation to include loans made outside the assessment area since it is much more likely to be the case with rent-a-bank payday lending. We know of no payday loans made by banks and third parties in the bank's own geographic area. South Dakota banks make loans in Georgia and Michigan. This is one reason why state bank supervisors are unlikely to take action against a state-chartered bank that makes usurious loans only to consumers in another jurisdiction and why the FDIC must step in to protect consumers and the deposit insurance fund.

FDIC Should Define Rent-a-Bank Features

Rent-a-bank payday lending is not legitimate brokering of bank loans by a third party. The third-party relationships and agreements section of the draft guidelines require examiners to assess an institution's risk management program for third-party payday lending relationships, including evaluation of a bank's risk assessment and strategic planning, and the bank's due diligence process for selecting a competent and qualified third party provider. It calls for a written contract with the third party and approval by the bank's board, including described duties and responsibilities of each party, performance measures or benchmarks, and responsibilities for providing and receiving information. Banks are urged to specify that the third party will comply with all applicable laws and regulations and establish which party will provide consumer compliance related disclosures. The guidelines require the third party to indemnify the bank for potential liability from action of a third party, a further indication that banks are merely renting their charters to partners who bear the risk of both the loans and liability for misdeeds.

Since we believe that rent-a-bank payday lending is a misuse of federally-insured nonmember banks, we note that this list of rules for doing it carefully does not address the fundamental question of whether FDIC insured nonmember state-chartered banks should be renting their charters to third parties in the first place.

Conclusion

We strongly urge the Federal Deposit Insurance Corporation to amend its draft guidelines for payday lending to:

- Definitively prohibit rent-a-bank payday lending by banks particularly in situations where the third party originates the product and uses the bank as a delivery vehicle, and the third party retains the preponderant economic interest in the loans.
- Clearly state that third parties cannot "rent" bank powers to export interest rates or preempt state laws.
- Strengthen guidelines for direct bank "payday lending" to require any small loan product to be based on the borrower's ability to repay and have adequate terms to repay without flipping

loans. Base bank CRA evaluation on small loans made outside the bank's assessment area as well as within it.

- Conduct compliance inspections at all nonmember banks that currently partner with third parties to make payday loans.