Americans for Financial Reform
1825 K St NW, Suite 210, Washington, DC, 20006
202.263.4533

Americans for Financial Reform CFPB Task Force

Memo to the Treasury Department
On Near-Term Priorities for Supervision and Enforcement of Payday Lenders at the Consumer Financial Protection Bureau

October 12, 2010

Contacts:

Jean Ann Fox
Director of Financial Services
Consumer Federation of America
1620 I Street, N.W. #200
Washington, DC 20006
direct: (928) 772-0674
email: jafox@cableone.net

Leslie Parrish
Senior Researcher
Center for Responsible Lending
910 17th Street NW, Suite 500
Washington, DC 20006
202-349-1854
Leslie.Parrish@responsiblelending.org

Lauren K. Saunders
Managing Attorney
National Consumer Law Center
1001 Connecticut Avenue, NW, Suite 510
Washington, DC 20036
202-452-6252 x 105
lsaunders@nclcdc.org

Summary

As the Consumer Financial Protection Bureau takes form, the following are near term priorities to create the infrastructure for effective supervision and enforcement of payday lenders:

- Define "payday loan" effectively to avoid evasions.
- Identify lenders to register and supervise.
- Conduct research on the risks of payday loans, security devices, and debt collection practices.
- Collect practices that subvert state law and need federal attention.
- Contact effective state regulators and prepare to supervise payday lenders.

Introduction: CFPB, Dodd-Frank Act, and Payday Lending

Over the last decade, payday loans ---the modern version of salary-buying[1] that triggered reforms in the last century ---have become the poster child for abusive small dollar lending that traps vulnerable consumers in unaffordable debt. The need to protect consumers from payday lending was a theme during the Congressional and public debate over creating a new agency to protect credit consumers. In fact, Congress gave the new CFPB specific authority to regulate all payday lenders, regardless of size, authority that the Dodd-Frank Act does not grant the CFPB regarding all non-banks.

Directly supervising payday loans and payday lenders is a new role for federal regulators. Section 1024 of the Act enumerates the non-depository providers over which the CFPB has supervisory authority, including undefined "payday lenders." Non-bank small loan companies are typically subject to state legal frameworks, licensing and supervision. While the Federal Trade Commission has had enforcement authority under federal credit and UDAP laws for payday lending, no federal agency has supervised this segment of the credit industry.
Since the CBPB must start from scratch to construct a regulatory framework for payday lending, we are providing suggestions for near term priority work on research, supervision, and enforcement of federal laws and preparation for organic rule-writing in this memo. Our organizations will provide further assistance in the future to expand on a legal framework for crafting rules to curb unfair, deceptive, and abusive acts and practices, as well as to apply the Fair Debt Collection Practices Act to this form of lending known for collection abuses.

---

[1] Salary-buyers loaned the working poor small sums to be repaid from that week's pay at rates similar to today's payday lending. This form of lending was tagged as "loan sharking." The resulting social upheaval led the Russell Sage Foundation to develop a model state small loan law that was enacted in many states to authorize small installment unsecured loans at 36 to 48 percent APR. For more information, see Uriah King and Leslie Parrish, "Springing the Debt Trap: Rate caps only proven payday lending reform," Center for Responsible Lending, December 13, 2007, at 5-6.

Payday Loans Are Predatory Small Loans That Trap Borrowers in Debt

High-cost "payday loans" are authorized by state law in the 34 jurisdictions where this form of small dollar loan is legal. (An additional four states license lower-cost forms of payday lending.) In many cases, these jurisdictions authorized payday loans by exempting them from pre-existing usury caps covering all other small loans. Typically payday loans are single payment loans of several hundred dollars, due in full on the borrower's next payday. Payday loans cost around 400 percent Annual Percentage Rate (APR) and are secured by/based on direct access to the borrower's next deposit of income into a bank account. Some lenders have expanded their loans to include loans secured by vehicle ownership, known as "car title loans". Loans are made at retail outlets and via the internet. While payday loans are advertised as a way to deal with an occasional financial emergency, most borrowers find themselves in long-term, high-cost debt traps. This is because the predatory structure of the payday lending business model sets these borrowers up for failure.[2]

The fundamental problems with the payday loan product which result in borrowers being trapped in long-term debt include: (1) the high annual percentage rate on these loans; (2) the short time period in which a borrower has to repay the debt in one balloon payment; (3) the holding of a check or access to the borrower's bank account as collateral; and (4) a lack of consideration of the borrower's true ability to repay.

These predatory elements of payday loans cause borrowers to take out one loan after another, without being able to fully retire their debt. The average payday borrower takes out nine loans a year and these loans tend to be taken on a consecutive basis, with more than one transaction per month. Getting stuck in a pattern of repeat borrowing, where a person takes out a loan each pay period, can adversely impact their finances in myriad ways. In most cases, a payday borrower is worse off than if they had never taken that first payday loan. Independent academic research demonstrates that payday lending increases a borrower's chances of filing for bankruptcy, becoming delinquent on a credit card, having a hard time paying other bills, delaying medical care and prescription drug purchases, and losing their bank account.[3]

---

[2] FDIC's Office of the Inspector General (OIG), Challenges and FDIC Efforts Related to Predatory Lending, Audit Report No. 06-011, June 2006. "Characteristics potentially associated with predatory lending include, but are not limited to, (1) abusive collection practices, (2) balloon payments with unrealistic repayment terms, (3) equity stripping associated with repeated refinancing and excessive fees, and (4) excessive interest rates that may involve steering a borrower to a higher-cost loan." Payday lending is listed as an example. "Payday Loans are small-dollar, unsecured, short-term advances that have high fees relative to the size of the loan. When used frequently or for long periods, the total costs can rapidly exceed the amount borrowed."

[3] Agarwal, Sumit, Skiba, Paige Marta and Tobacman, Jeremy Bruce. Payday Loans and Credit Cards: New Liquidity and Credit Scoring Puzzles? (January 13, 2009) http://ssrn.com/abstract=1327125; Paige Marta Skiba and Jeremy Tobacman, "Payday Loans, Uncertainty, and Discounting: Explaining Patterns of Borrowing, Repayment, and Default," August 21, 2008. http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=1636; Paige Marta Skiba and Jeremy Tobacman, "Do Payday Loans Cause Bankruptcy?" October 10, 2008 http://www.law.vanderbilt.edu/faculty/faculty-personal-sites/paige-skiba/publication/download.aspx?id=2221; Dennis Campbell, Asis Martinez Jerez, and Peter Tufano, "Bouncing Out of the Banking System: An Empirical Analysis of Involuntary Bank Account Closures," June 6, 2008 www.box.frb.org/economic/eprg/conferences/payments2008/campbell_jerez_tufano.pdf.

Congress enacted legislation in 2006 to effectively ban payday lending to Service members and their families. The John Warner Defense Authorization Act for Fiscal Year 2007 banned the use of unfunded checks, compulsory debits, and vehicle titles as security for loans and capped rates for covered credit per Department of Defense rules at 36 percent APR inclusive of fees. While the CFPB cannot establish a usury cap for loans, it is empowered to extend the Military Lending Act protections against unfair forms of loan security to all Americans and to address other unfair, deceptive or abusive aspects of payday lending.

Define "Payday Loan" and "Payday Lender" Effectively

The Dodd-Frank Act provides the CFPB authority over all payday lenders but does not define "payday loan." It is extremely important to define a "payday loan" in such a way that does not invite evasions and allow lenders to escape coverage of loans targeted at the same population and with the same pernicious effects.

The payday loan industry has a history of using a wide variety of loan structures to avoid consumer protections, when the terms of covered loans are not carefully and comprehensively defined. Indeed, skirting definitions of "payday loan" through subterfuge is not something that payday lenders do every once in a while; it is central to the way they do business. A definition needs to be flexible and should not provide a roadmap of how to structure a product to avoid the definition.

The experiences of both the Department of Defense and the states provide examples of the type of definitional features to avoid:

- *Form of security:* A definition tied to the traditional check holding model will lead to evasions. When authorization for payday lending expired in Arizona, many former payday lenders became "title" lenders, making loans based on the borrower's vehicle title or a copy of the vehicle registration card for consumers who did not own cars free and clear. Virginia experienced migration back and forth between payday and car title lending as loan companies sought the most lenient regulation. Car title loans are often interchangeable products with payday loans, especially when borrowers do not hold title to the vehicle that purportedly "secures" the title loan. Even when loans are secured by the title held by the borrower, consumers experience the same debt trap pattern of paying only interest every month while not retiring the loan to avoid loss of the vehicle. "Payday loans" should be defined to include car title loans.

- *Open v. closed end credit.* DOD defined covered payday loans as closed-end loans. While most payday loans were traditionally closed-end credit, lenders that morphed their product to an open-end line of credit avoided the protections of the Military Lending Act. The same happened recently in Virginia, as lenders changed their product from closed-end to open-end to evade efforts to end payday lending there.

- *Length of the loan*. When Illinois defined payday loans as loans of 120 days or less, the lenders created 121-day loans to avoid coverage. A similar phenomenon occurred in New Mexico when lenders extended the loan term to 35 days and began calling their loans "installment loans" to evade legislative efforts to curb payday lending abuses.

- *Fragmentation of the loan and lender*. In Texas, payday lenders avoided state law usury caps by posing as brokers, calling themselves credit services organizations and collecting the bulk of the loan revenue as a brokerage fee. In the aftermath of the Ohio rate cap referendum and rate cap law, Ohio payday lenders have been using a similar scheme to avoid the voter and legislator approved 28% rate cap. These schemes similar to the payday lenders' older rent-a-bank ruse, which was effectively put to an end by the FDIC in 2005. Prepaid card payday loans involve several parties, some banks, some nonbanks, each adding to the cost of a loan.

The process of collecting data from the states and beginning to register lenders should help inform the definition of "payday loans" and help ensure it is not too narrow or easily evadable. We look forward to working with CFPB to craft a definition that covers all small dollar, short term loans that put key family assets at risk.

Research Agenda: Collect Information to Evaluate Risk and Size of Product Sectors

CFPB's research unit is assigned the functions of "researching, analyzing, and reporting on developments in markets for consumer financial products or services, including market areas of alternative consumer financial products or services with high growth rates and areas of risk to consumers; access to fair and affordable credit for traditionally underserved communities…." The research unit will be important to building the base for dealing with payday lending. Information must be collected to enable CFPB to describe product characteristics, market presence, and loan use impact on consumers to set priorities for supervision, enforcement and rule-writing. We recommend that initial CFPB research and information collection efforts address three priorities: Information to enable the agency to identify and register all lenders, research to determine the debt trap pattern of use caused by the payday loan product design, and information on the risks and abuses inherent in loans secured by direct access to a borrower's income, exempt funds, and key family assets.

1. Identify Lenders to Register and Supervise

We recommend that the CFPB, in partnership with state regulators, construct a master list of all licensed payday loan providers, although the status of payday lending varies by state. Thirty-eight state financial regulators and banking departments license payday loan outlets. Hawaii is the only state that authorizes the payday loan product but does not license lenders. In some states with relatively low rate caps, such as New Hampshire, while payday lending is legal, no lenders remain in the market to be licensed. Some states regulate payday lending as part of check casher supervision, such as Rhode Island, while others regulate the payday product as part of the larger body of consumer lenders. In Texas the Office of Consumer Credit Commissioner licenses payday lenders that comply with Texas Finance Commission rules while the bulk of the industry operates as credit services organizations, which must only register with the Secretary of State. In Ohio, most payday lenders faced with a 28 percent APR rate cap morphed their products to be licensed under other small loan laws. Illinois recently enacted legislation attempting to stop payday lenders from escaping modest loan limits by becoming Consumer Installment Loan Act lenders. (See Appendix A). And while New Mexico has a payday loan law, virtually all of the actors are in fact operating under installment loan law.

Trade associations for the industry should be requested to provide their member lists. These include the Community Financial Services Association, the Financial Service Centers of America, and the Online Lenders Alliance, as well as state-level trade associations such as United Payday Lenders of Missouri, Kentucky Deferred Deposit Association, and Colorado Financial Services Centers Association (CoFisca). While CFSA's member list is available online, the trade group for online lenders has not disclosed its roster. Industry analysts, such as Stephens Inc., report on publicly traded companies and larger industry players. Securities and Exchange Commission filings by publicly-traded lenders are another source of information.

Identifying all payday lenders that conduct business online is a more challenging task. Some states require online lenders to become licensed or registered in order to extend credit to state residents. While we believe that all internet lenders are subject to state jurisdiction, compliance with state licensing is not nearly as widespread as it is with brick and mortar stores. Online lenders that also have a physical presence in a state are more likely to be licensed in each state in which they extend credit. The Utah Department of Financial Institutions requires out-of-state online payday lenders to register, which provides a start to compiling this information. (Utah registration list attached.) CFA is working with state regulators to construct a master list of online payday lenders and will provide that resource to CFPB on completion.

Some online lenders claim to be located outside the United States, but CFPB can track down these lenders by identifying the banks that process their transactions through the ACH system. We recommend that CFPB ask prudential regulators to require all banks to submit information on processing automated clearinghouse transactions for online payday lenders. Internet payday loans are delivered and collected via the electronic fund transfer network, which consists of an acquiring bank and a receiving bank for each transaction. National Automated Clearing House Association (NACHA) indicates that international ACH does not include full capability; therefore, any off-shore online lender using the ACH system to deliver and collect loan proceeds must have a domestic bank to complete the loan transaction. Third-party payment processors may stand between the payday lender and the acquiring bank. Prudential regulators should be able to require disclosure of these business arrangements to help the CFPB identify and locate all online payday lenders and determine the volume of loan transactions delivered and collected via the ACH system. The CFPB may consider using its current coordinated supervision authority under section 1025(e) to access this information from large banks.

In the minority of states that permit high-cost, short-term loans based on the title to the borrower's vehicle, states either license these lenders separately or in the general category of small loan companies. Our organizations will furnish the CFPB staff an update car title loan law list in the near future.

2. Collect Information Regarding Effects of Payday Lending on Borrower Debt and Finances

The CFPB should start now to collect information available to document the financial impact of payday loan use on borrowers. Our organizations and independent academic researchers have issued reports and papers describing the adverse consequences to consumers of using payday

loans, including involuntary bank account closures, difficulty paying other bills, and higher rate of bankruptcy filing.[4]

A cross-section of brick and mortar payday loan and car title loan stores and online lenders should be required to provide information to describe their products, credit extension practices, customer loan use pattern, number of days of borrowers' indebtedness, demographics of borrowers, source of income, default rates, the lenders' profitability/loss rates, collection tactics, and other information. Our organizations have extensive information about payday lending and would be glad to share that with CFPB staff to help design a data collection project.

In addition, prudential regulators should be requested to provide information on the use of demand drafts by credit providers and the extent to which e-checks (demand drafts processed through the Check 21 system) are used by lenders. (The use of e-check demand drafts is touted as a means of evading NACHA rules.) Financial institutions may also have information to further correlate payments to payday lenders with incidence of overdraft fees, nonsufficient funds, and account closures.

Credit reporting bureaus are another source of information. Payday lenders report delinquencies to the major credit bureaus and some lenders report payments to specialized reporting agencies. Given their broad view of the consumer's finances, credit bureaus should be able to shed additional light on the effect of payday loans on consumers.

CFPB could also request payday lenders' reports filed by licensees with state regulators, either on a company basis or as part of a state's annual report. A few states require all lenders to report loans to a central database, including Florida, Oklahoma, Virginia, Illinois, Michigan, Washington, North Dakota, Kentucky and South Carolina. While some information from these databases is publicly reported, the database operator has extensive information on loan use patterns which CFPB should acquire and analyze. Most payday lenders also use Teletrack, which tracks borrowing and defaults. Consumer organizations will share our research and reports on payday and car title lending and can provide feedback on the validity of industry-supported research.

3. Collect Information Regarding Effect of Security Devices Used by Payday Lenders on Borrower Debt and Finances

Payday loans are based on or secured by direct access to the borrower's deposit account or by ownership of a family asset, such as ownership of a vehicle. In addition to high cost and short repayment terms, one reason why most borrowers roll over payday loan debt multiple times is the adverse consequence of failing to repay the loan in full on the due date. These include: fees levied by both the payday lender and the consumer's bank when the payday loan check is deposited with insufficient funds; the consequences for other outstanding or upcoming payments such as rent when checks written for payday loans deplete funds, causing other checks to bounce; the loss of the ability to write checks due to adverse reports to check screening system; the loss of a vehicle to repossession, and the threats of criminal sanctions for "failure to make good on the check."

[4] See: http://www.paydayloaninfo.org/issues.asp, first item.

As payday lending has expanded from being based on paper checks to being based on compulsory debits, privacy and security risks have been magnified. Borrowers must supply bank account numbers and Social Security numbers in online loan applications. Some payday lenders allow themselves to create a demand draft (or remotely created check) in the fine print of their contracts, which allows them to withdraw funds from the borrower's account if the consumer revokes authorization to electronically repay the loan.

Consumer organizations, including NCLC and Consumers Union, have proposed several reforms to protect consumers who now use payday and car title loans. These include a ban on dangerous forms of security for small dollar loans, including check holding, mandatory electronic access to the consumer's bank account, and holding car titles. CFA also supports a ban on the use of demand drafts and e-checks to take payment from consumers' accounts and to deprive consumers of protections under EFTA or NACHA rules.

The CFPB should request that state regulators provide any data on the frequency of returned checks due to insufficient funds, fees collected by payday lenders from borrowers for returned checks, and lawsuits filed by payday lenders to collect on unfunded checks. The CFPB could ask prudential regulators to request that banks provide information on the frequency of bank account closure among known payday borrowers, any difficulty consumers have in exercising EFTA rights to revoke authorization for periodic debits to repay loans, and any incidents of demand drafts/e-checks used to withdraw payment from accounts.

The CFPB could also ask the National Automated Clearing House Association to share information on the frequency of consumers complaining about unauthorized debits for single debit payments made via the Internet or telephone for payday loan transactions (WEB and TEL in NACHA codes). The Atlanta Federal Reserve Bank has extensive information on the use of demand drafts, a feature of some Internet payday loan contracts. The Federal Trade Commission has sued online payday lenders for unauthorized debiting of payday loan borrowers' bank accounts and could provide insights into this risk to borrowers.

4. Investigate Debt Collection Abuses by Payday Lenders for Consideration of Rules On Unfair Collection Practices

Debt collection tactics used by payday lenders, their collectors, and fraudsters who collect nonexistent loans are a particular problem in this sector. While third-party debt collectors have been subject to the Fair Debt Collection Practices Act (FDCPA), payday lenders collecting their own debt have not. Dodd-Frank gave the CFPB authority over lenders collecting their own debts, whose debt collection activities are currently unregulated at the federal level. The CFPB should begin collecting information on payday lenders' debt collection practices in order to determine whether the unfair debt collection practices that are banned in the FDCPA should also be banned for payday lenders. (See CFA and NCLC Comments to FTC Debt Collection Workshop.) The CFPB should also explore payday lender compliance with the FTC's credit practices rule, which does apply to payday lenders. The FTC recently settled with one online lender that claimed to be able to garnish wages to collect payday loan debts.

The Better Business Bureau has issued repeated warnings about harassing debt collection calls made to consumers who have never had or do not now owe Internet payday loans. These collectors have extensive financial information about consumers, leading the BBB to conclude that data breaches may be the cause of the collection calls. The West Virginia Attorney General is widely quoted on phony payday loan debt collection tactics but to date has not brought an enforcement action due to difficulty in identifying or locating the collectors. The CFPB should request assistance from federal law enforcement agencies to help identify the source of harassing debt collection calls to American consumers.

Collect Information on Federal Help Needed to Avoid Evasions of State Law

States have been frustrated in their efforts to address payday lending by some manipulations that are beyond their control. The CFPB should collection information on where federal help is needed to support state law efforts. Issues include:

- Some payday lenders have taken advantage of loopholes in the APR definitions in the Truth in Lending Act to charge application, participation and other fees that are not included in the APR and result in an abnormally low interest rate.
- Some payday lenders have affiliated with Native American tribes in order to invoke tribal sovereign immunity to avoid state laws. A challenge to the tribal immunity claim is before the Colorado Supreme Court, while the West Virginia Attorney General has settled cases with online payday lenders claiming tribal immunity. Tribes are not immune from federal law, however.
- Payday lenders, especially online lenders, may use choice of law provisions to avoid state law.
- Payday lenders may broker a loan for a depository or non-depository institution.
- Forced arbitration clauses force payday borrowers into a forum that is often secretive, biased and lawless.
- Some payday lenders are involved in issuance of prepaid debit cards with a loan advance feature that appear aimed at evading state law. A payday lender or check casher and prepaid card provider may partner with a bank in order to take advantage of preemption.

Begin Supervision and Enforcement of Payday Lenders

Payday lenders, broadly defined, have a poor track record of complying with federal credit laws. The FTC has brought enforcement actions, citing violations of the Truth in Lending Act, Electronic Fund Transfer Act, and other credit laws while private litigation has identified failure to comply with these laws as well. The FTC has not had the resources to systematically oversee payday lenders for compliance with federal credit laws. We recommend that the CFPB make compliance with existing federal laws an early priority. For example, advocates have provided documentation to the FTC to the effect that payday loan stores do not routinely quote the APR when consumers ask what loans cost.

Our organizations have conducted an analysis of payday lending based on the provisions of the FTC Act that prohibit unfair and deceptive acts and practices (UDAP). We will provide the CFPB an expanded version of this analysis to include examples of abusive acts and practices, as defined by Dodd-Frank.

The CFPB could partner with states to bring enforcement actions against payday lenders that operate in or make loans to consumers who live in their states.

Identify Effective State Regulators

As the CFPB builds a federal supervision structure, it should identify state regulators who have been effective in enforcing their laws. Setting aside judgments on the strength of the law itself, some states are better than others in enforcing the laws they have. In considering state regulatory partnerships, we recommend that CFPB look for these features of effective state regulation:

1. Proactively enforces licensing requirements and substantive consumer protections with both storefront and online lenders;
2. Provides annual reports or database reports to inform policymakers about lending patterns;
3. Makes actionable consumer information and advice available and posts information on agency websites.

Examples of constructive state regulatory work include:

- Colorado Attorney General's Uniform Consumer Credit Code Administrator's cumulative data collection program. Since 2000, the Colorado payday loan regulator has collected borrower loan use data from a sample of consumer files as licensees are inspected. This large data set is posted online, updated each year, and is a valuable resource for understanding how payday loans are used. The Colorado regulator is a leader in enforcing state regulatory requirements with out-of-state lenders and online lenders.
- Washington Department of Financial Institutions publishes annual reports quantifying payday loan volume and use patterns. The agency in past years has conducted consumer education campaigns and currently posts useable information on its website. The agency has a long record of enforcement cases against unlicensed lenders and lenders that violated state law.
- The Kansas Commissioner of Banks cited unlicensed online lenders and won a key federal court decision upholding state jurisdiction over Internet payday lenders. The regulator compiled information on car title lending to present to legislators.
- The West Virginia Attorney General's office has brought more than a hundred enforcement actions against high-cost small dollar lenders that extend credit to state residents in violation of West Virginia's 36 percent rate cap. West Virginia officials have extensive experience in identifying Internet payday loan companies. The state settled cases against retail payday lenders located in surrounding states on debt collection tactics used in West Virginia.

- The North Carolina Commissioner of Banks and the Attorney General's office have strong track records of policing the payday loan sector. During its experiment with legal payday lending, North Carolina regulators collected and publicized loan use data. When the payday loan law expired, state officials systematically challenged the ruses and shams attempted by payday lenders to stay in business. And, the Commissioner had the University of North Carolina conduct a study of the aftermath of payday lending on borrowers.
- The Indiana Department of Financial Institutions has actively enforced its laws against lenders that sought to use creative tactics to evade state rules, including "internet use rebate" lenders and car title lenders located outside Indiana that failed to comply with the state's jurisdiction.
- State Attorneys General in Arizona, Massachusetts, New York and Arkansas have also been strong in efforts to address payday lending.

We look forward to working with you to build a strong and effective Consumer Financial Protection Bureau.