

## FINANCIAL INSTITUTIONS

### NEW RESTRICTIONS ON BANK "PAYDAY LOANS"

by John K. Lawrence

Federal bank regulatory agencies have served notice that deposit advance products, sometimes known as bank "payday loans," will soon be subject to significant new restrictions and heightened supervisory scrutiny. In coordinated actions, the Federal Deposit Insurance Corporation ("FDIC") and the Office of the Comptroller of the Currency ("OCC") announced proposed Supervisory Guidance that will mandate significant changes to the practices of State-chartered non-member banks and national banks offering such products.<sup>1</sup> The Supervisory Guidance is open for comment for 30 days.<sup>2</sup>

This Client Alert considers the proposed OCC/FDIC Supervisory Guidance in detail, and also addresses the narrower response to the CFPB study issued by the Board of Governors of the Federal Reserve System (the "Board") that applies to State-chartered member banks.<sup>3</sup>

The OCC and FDIC are assertively using supervisory authority to impose new restrictions on deposit advance products. By contrast, while emphasizing the importance of compliance with applicable law and the mitigation of risks to consumers through the design and operation of such products, the Board appears to be deferring to the CFPB in respect of imposition of new restrictions.

#### Background

Deposit advance products ("DAP") are small-dollar, short-term credit products offered by banks to their deposit account customers who have had their accounts for some minimum period of time and who receive recurring direct deposits (such as pay from their employers). A bank allows the customer to receive a loan, typically on an open-end basis, in anticipation of subsequent direct deposits. Currently, such loans are generally based on the amount of recurring direct deposits to the customer's account, instead of a traditional underwriting of the loan.

A customer who receives a loan is charged a flat fee per advance (such as \$2 for each \$20 advanced) rather than interest. The advance and fee are automatically repayable in a lump sum, not on a fixed date, but as soon as direct deposit(s) are received by the bank. If those deposits are insufficient to pay the advance and fee in full within a stated time, often 35 days, the bank debits the deposit account for the unpaid amount, even if an overdraft results. In general, the bank is paid first, before any other transactions on the deposit account are paid.

Banks offering DAP have marketed them as intended to assist customers through a financial emergency or to meet short-term needs. Typically, these products have not been included in listings of the bank's available credit products, but instead have been described as a deposit account "feature."

The FDIC and the OCC (the "Agencies") believe that such products share a number of characteristics with payday loans by non-depository lenders. These include high fees, very short, lump-sum repayment requirements,

and inadequate attention to the borrower's ability to repay. This is perhaps not surprising, as DAP evolved, in part, as a response to restrictions imposed by the OCC in 2000 on direct participation by national banks in the payday lending market.<sup>4</sup>

Payday lending has been prohibited by State law in some 15 States. Some other States, such as Michigan, while permitting payday lending, have subjected it to stringent regulation. Those State law restrictions, however, in many instances do not apply to regulated depository institutions. In their current releases, the OCC and the FDIC indicate their intent closely to review banks that offer or propose to offer DAP.

#### Proposed Supervisory Guidance

The general approach of the proposed Supervisory Guidance is to focus on safety and soundness issues, resulting in large part from the absence of traditional credit underwriting regarding DAP loans, and the potential compliance issues with applicable consumer protection law and regulations. After reviewing those concerns, the proposed Supervisory Guidance specifies the Agencies' requirements for banks engaging in such lending activity.

#### Safety and Soundness Considerations

In the Agencies' view, the combination of a high-cost product and short repayment period creates a risk of some customers becoming trapped in a cycle of high-cost borrowing over an extended period of time.<sup>5</sup> This cycle, referred to as "churning" of loans, is characterized by the Agencies as "similar to" the practice of "loan-flipping," which they have previously identified as an element of predatory lending.<sup>6</sup> The Agencies state that the design of these products often results in such consumer behavior and is "detrimental to" the customer. Although so-called "cooling off" periods, that is, minimum times imposed between deposit advances, have been instituted by some banks, the Agencies find the existing forms of such arrangements to be "easily avoided" and "ineffective" in preventing repeated usage.

The Agencies note that because customers using DAP often have cash flow difficulties or blemished credit histories, such loans present an elevated credit risk to lending banks. Failure to consider adequacy of income sources to cover ordinary living expenses and other debt of such customers before making repeated deposit advance loans presents safety and soundness concerns. These include clouding the true performance and delinquency status of the loan portfolio and heightened default risk. These underwriting shortcomings are addressed in the changes mandated by the proposed Supervisory Guidance.

Reputational risk is presented by negative news coverage and public scrutiny of DAP loans. The perception that DAP are unfair or detrimental to customers can result in both reputational damage and direct legal risk from private litigation and regulatory enforcement actions.

The Agencies also highlight the involvement of third-party contractors in the development, design and servicing of DAP offered by some banks. Use of such contractors may increase legal, operational and reputational

risk for the bank involved, among other things because the bank is responsible to supervise legal compliance by such contractors.

### Compliance and Consumer Protection

The Agencies observe that deposit advance products must comply with applicable State and Federal law and regulations. Such State restrictions may include not only usury laws, but also laws on unfair or deceptive acts or practices. Each bank offering DAP should have its counsel review all such products prior to implementation.

Among the Federal laws and regulations involved, the proposed Supervisory Guidance highlights the Federal Trade Commission ("FTC") Act, the Truth-in-Lending Act ("TILA"), the Electronic Fund Transfer Act ("EFTA"), the Truth in Savings Act ("TISA"), and the Equal Credit Opportunity Act ("ECOA"), and their respective implementing regulations.

Section 5 of the FTC Act prohibits unfair or deceptive acts or practices ("UDAP"). Marketing materials and operational practices for deposit advance products may give rise to UDAP concerns if they are not clear, conspicuous, accurate and timely, or if they do not fairly describe the terms, benefits, potential risks, and material limitations of the products.

TILA and its implementing Regulation Z require specific cost disclosures in specified form for consumer credit extensions. This includes an annual percentage rate disclosure (using that term) for each extension. They also regulate the content of advertising materials for such products.

EFTA and its implementing Regulation E also require specified disclosures to customers. Further, they prohibit creditors from requiring repayment of loans by "preauthorized electronic fund transfers," and enable a customer to withdraw authorization for "preauthorized electronic fund transfers" from the customer's account.

Because DAP involve a customer's deposit account, they are subject to TISA and its implementing Regulation DD. Among other things, TISA requires disclosures regarding any fee that may be imposed in connection with the account, and regulates advertising and solicitation materials regarding the account.

ECOA and its implementing Regulation B prohibit discrimination on a prohibited basis in any aspect of a credit transaction. They could be implicated, for example, by any discretion exercised by a bank in the application of eligibility criteria or fee waivers, or by "steering" or targeting of certain customers for deposit advance products, as well as by the procedures applicable to credit denials or other forms of adverse action by the lending bank.

### Supervisory Expectations

Because of the "significant" consumer protection and safety and soundness concerns presented by DAP, the Agencies specify in the Supervisory Guidance prescriptive supervisory measures that they will take in future in dealing with banks that offer or propose to offer DAP.

The Uniform Retail Credit Classification and Account Management Policy will now be applied so as to give examiners discretion to classify individual loans, loan portfolios, or segments of portfolios, if they display credit weakness, *without regard to delinquency status*. The Agencies state that deposit advance loans that have been accessed repeatedly or for extended periods "are evidence of 'churning' and inadequate underwriting." These statements imply that classification of existing DAP loans is likely.

In assessing bank underwriting and administration of DAP loans, examiners will look for written policies and procedures designed to assure that (i) customers receiving such loans have the capacity to meet typical recurring expenses (food, housing, transportation, and health care) and other debt, as well as the DAP loans, and (ii) churning and prolonged use of DAP are avoided. Repetitive usage of such loans "will be criticized in the Report of Examination and taken into account in an institution's [CAMELS] rating."

Bank underwriting policies on DAP must be reviewed and approved by the bank's board of directors, and must be consistent with its general underwriting standards and risk appetite. The following six factors will be required as part of the policy:

1. To be eligible for DAP loans, a customer must have had his/her deposit account for at least six months.
2. Customers with any delinquent or adversely classified credit should be ineligible.
3. The bank should conduct an analysis of the customer's financial capacity, including income level, and consider ability to repay without needing borrowing from any source (including re-borrowing under the DAP). This will require an analysis of the deposit account for recurring deposits (inflows) and checks, credit, and customer withdrawals (outflows) over at least six consecutive months. In that analysis, any form of credit (including overdrafts) or transfers from savings are to be disregarded as inflows. The bank must identify the customer's net surplus or deficit at the end of each month during the six-month period, and not rely on a six-month transaction average. Following this analysis, the bank must determine whether an installment repayment arrangement is more appropriate.
4. Each DAP loan should be repaid in full before the extension of a subsequent DAP loan, and not more than one DAP loan should be offered in a monthly statement cycle. The Agencies state that lending to a borrower who does not demonstrate ability to repay the loan, as structured, from sources other than the collateral pledged (here effectively the deposit account) is an unsafe and unsound practice and "should be criticized in the Report of Examination as imprudent."<sup>7</sup>
5. An increase in a customer's DAP credit line may not be made without a full underwriting reassessment. Moreover, an increase may be provided only at the customer's request, not automatically by the bank.

6. Underwriting must include a reevaluation, every six months, of the customer's eligibility and capacity for the deposit advance program. This should include identification by the bank of risk factors, such as repeated overdrafts (based on a specified number per month during a specified period of months) or other evidence that the customer is overextended on his/her total credit obligations.

On capital and earnings issues, the Agencies note that loans exhibiting subprime characteristics (as the document suggests is the case with current DAP loans) may require higher levels of capital. They also remind banks that undue reliance on fees for revenue and earnings may be inconsistent with safe and sound banking principles. Regarding the adequacy of the allowance for loan and lease losses ("ALLL"), the Agencies state that examiners will determine whether the methodology and analyses used with respect to DAP loans are sufficient to demonstrate that the ALLL level is appropriate.

Finally, in assessing the quality of management of the bank, examiners will be looking carefully at several DAP-related issues. One area will be compliance by the deposit advance products with the consumer protection laws and regulations noted above. Another is the existence and implementation of controls and analytic processes to identify, measure, and manage risks (including risks of financial losses, reputational damage, legal compliance and supervisory action) associated with DAP loans. Management must also supervise compliance and performance of any third-party contractor involved in any phase of its deposit advance program. Regular reports on such matters must be provided to the board of directors or a responsible board committee.

#### Action By the Federal Reserve

The Board, as primary Federal regulator of State-chartered member banks (some of which are significant DAP lenders), did not join its sister agencies in adopting the proposed Supervisory Guidance. Instead, it issued a short statement directed to State member banks on the same day as the FDIC and OCC issued the proposed Supervisory Guidance.<sup>8</sup>

In its Statement, the Board notes the CFPB's preliminary findings and emphasizes to State member banks the "significant risks" associated with DAP, including potential consumer harm and elevated compliance risks in designing such products. The Statement notes the compliance issues under all of the Federal statutes discussed above, and also under Section 1036 of the Dodd-Frank Act, which prohibits unfair, deceptive, or abusive acts or practices, as well as under State law and regulations.

The Board Statement emphasizes the UDAP prohibition in Section 5 of the FTC Act, noting that it applies to all aspects of DAP, including marketing, servicing and collections. The Statement provides that examiners will "thoroughly review" deposit advance products for compliance with FTC Act Section 5, as well as all other applicable laws and regulations.

In its Statement, the Board also notes the involvement of third-party vendors in some banks' programs, and highlights the increased consumer and compliance risk that can result from inadequate

management oversight of such vendors. It stresses that fee-sharing or similar arrangements with such vendors can create incentives for inappropriate sustained usage of DAP loans by consumers. The Board expects State member banks to develop procedures closely to monitor vendor practices and outcomes, and to mitigate and manage consumer and compliance risks in the design and marketing of any deposit advance products they offer.

#### Conclusions

A review of the proposed Supervisory Guidance makes clear that the OCC and the FDIC appear intent on pursuing a rigorous campaign to alter fundamentally the practices of banks subject to their regulatory oversight that engage in deposit advance lending. The Agencies assert that they will use a full range of persuasive and examination authority, including potential reductions in CAMELS ratings (with attendant implications for deposit insurance assessments), to accomplish their objectives.

Perhaps coincidentally, in coordinated actions three business days following release of the proposed Supervisory Guidance, the OCC and the FDIC imposed civil money penalties totaling \$10 million and restitution orders aggregating \$3.9 million on RBS Citizens, N.A. and an affiliate for violations of the UDAP provisions of Section 5 of the FTC Act in connection with overdraft payment and checking rewards programs, and improper handling of stop-payment requests regarding pre-authorized recurring electronic fund transfers.<sup>9</sup> These actions followed other consumer protection enforcement orders earlier in 2013 by the OCC and the FDIC.

Taken together with the proposed Supervisory Guidance, the OCC and FDIC orders suggest a reinvigorated attitude to consumer protection matters at the Agencies. It would therefore be advisable for national banks and State-chartered non-member banks to consider carefully the changes that would be required under the proposed Supervisory Guidance in connection with any existing or contemplated deposit advance program.

The OCC and FDIC proposal on DAP comes at a time when the CFPB, the primary Federal consumer protection regulator of large institutions, is actively studying the same issue. Based upon its preliminary findings, the CFPB indicates that it will also be acting in the future on DAP relative to entities subject to its regulation.

The Board's Statement reflects an approach different from that of the Agencies to the DAP issue. The Board emphasizes that its examiners will thoroughly review all aspects of a bank's deposit advance program for compliance with applicable law (including the UDAP provisions of Section 5 of the FTC Act). It also points to risks arising from the use of third-party contractors, especially where fee-sharing or other arrangements create incentives for inappropriate overuse of DAP loans. Further, it directs State member banks to mitigate risks through product design and to implement procedures closely to monitor third-party vendor practices and outcomes. It does not, however, impose new prescriptive measures through the use of supervisory tools.

The significance of this difference is not entirely clear. It may be a timing question only. Because the banks supervised by the Board which offer DAP loans tend to be large enough to be subject to CFPB regulation, the Board may simply be deferring policy-making on the issue to the CFPB. The Board may feel its approach comports favorably with the allocation of primary responsibility for consumer protection issues to the CFPB under the Dodd-Frank Act.

The OCC and the FDIC, however, each supervise many more banks which are below the \$10 billion threshold for entities subject to direct CFPB regulation. The Agencies' action may stem from a desire to limit the spread of DAP beyond those supervised banks already offering such products. Whatever the motivation, the Agencies' proposed Supervisory Guidance is a more assertive use of supervisory authority than the Board's Statement.

Irrespective of the divergence in regulatory approach, it is apparent that deposit advance products will be attracting a higher level of regulatory scrutiny. While national banks and State non-member banks must do so, even State member banks, if they have an existing or contemplated deposit advance program, would do well to consider the nature and scope of the new requirements described in the proposed Supervisory Guidance.

<sup>1</sup> OCC News Release NR 2013-69 (April 25, 2013); FDIC Press Release PR-31-2013 (April 25, 2013).

<sup>2</sup> On the preceding day, the Bureau of Consumer Financial Protection ("CFPB") released a study on payday loans and deposit advance products. It is based upon analysis of data regarding both payday loans made by non-depository lenders and eligible consumer deposit accounts at banks offering deposit advance products. The CFPB noted that its findings raised "substantial consumer protection concerns," and indicated that it "expects to use its [regulatory] authorities to provide such protections." Payday Loans and Deposit Advance Products (CFPB, April 24, 2013) at 44-45.

<sup>3</sup> Statement on Deposit Advance Products, CA 13-7 (April 25, 2013).

<sup>4</sup> OCC Advisory Letter AL 2000-10 (Nov. 27, 2000). As part of its current action, the OCC withdrew an earlier proposed guidance covering both DAP and automated overdraft protection products. 76 Fed. Reg. 33409 (June 8, 2011). The current proposed Supervisory Guidance does not apply to overdraft lines of credit.

<sup>5</sup> This is supported by data in the CFPB study, which showed that a majority of the DAP users in its sample took advances totaling over \$3,000, and tended to be indebted for advances for over 40% of the year, with a median time between repayment and new advances of 12 days or less.

<sup>6</sup> Interagency Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001), OCC NR 2001-12, FDIC PR-9-2001.

<sup>7</sup> The FDIC further expects State-chartered non-member banks, by analogy to its 2005 Guidelines for Payday Lending, to ensure that loans are not made to customers who had payday loans outstanding with *any* lender (not just the bank) for a total of three months in the previous 12 months. This will require such FDIC-supervised banks to monitor State payday lending databases, or incoming checks or ACH transactions involving known payday lenders.

<sup>8</sup> Statement on Deposit Advance Products, CA 13-7 (April 25, 2013).

<sup>9</sup> OCC NR 2013-73 (April 30, 2013); FDIC PR 35-2013 (April 30, 2013).

*This Client Alert is published by Dickinson Wright PLLC to inform our clients and friends of important developments in the field of financial institutions law. The content is informational only and does not constitute legal or professional advice. We encourage you to consult a Dickinson Wright attorney if you have specific questions or concerns relating to any of the topics covered in this Client Alert.*

FOR MORE INFORMATION CONTACT:



**John K. Lawrence**, is a member in Dickinson Wright's Detroit office. He can be reached at 313.223.3616 or [jlawrence@dickinsonwright.com](mailto:jlawrence@dickinsonwright.com).