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Payday Loans: Federal Regulatory Initiatives

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Summary

A payday loan arrangement permits an individual to use a personal check to get a small, short-term, cash advance. The loans are typically for \$100-\$500. The borrower writes a postdated check for the loan amount and a fee. The lender holds the check until the borrower's next payday, usually two weeks. This source of short-term credit can be expensive. The fee charged on a 14-day payday loan is typically \$15 to \$17 per \$100 advanced, amounts equivalent to an APR (annual percentage rate) of between 391% and 443%. A loan can become even more expensive if it is rolled over or extended.

State laws have generally governed payday lending; some are silent while others have prohibited or restricted payday lenders. Payday loans are subject to the disclosure provisions of the federal Truth-In-Lending Act. When payday lenders attempted to partner with banks and thrifts to circumvent restrictive state laws, however, federal regulators issued supervisory guidance relating to payday loans. Depository institutions were cautioned that these arrangements introduced financial, compliance, and reputation risks. Consumer advocates are concerned that these guidelines may not provide sufficient consumer protection. They have called on Congress to examine the activities of payday lenders to see if reforms are needed to protect consumers. Legislation, H.R. 1643 and H.R. 1660, that would regulate the payday lending has been introduced. This report provides information on the practice of payday lending and an overview of federal regulation and legislation. This report will be updated as events and legislation warrant.

Background

The payday loan industry became a popular source of funds for cash-strapped borrowers in the 1990s. Payday loans were originally offered through check cashing outlets and pawnshops. The market for this financial product soon produced stand-alone payday loan businesses. Today the industry includes large regional or national payday loan businesses. Some providers are multi-service, offering a range of financial services (for example, money orders and check cashing) as well as payday loans. Nationwide, payday loan offices increased from approximately 300 in 1992, 10,000 in 2000, to almost

22,000 in 2003. The total dollar volume of payday loans in 2003 was approximately \$40 billion.¹

In a payday loan transaction, the lender makes a small advance (typically \$100-\$500) to its customer, agreeing to hold a personal check for the loan amount plus a fee until the customer's next payday. Sometimes the advance is made in exchange for the authorization to debit electronically the customer's checking account for the loan amount plus the fee. The borrower receives cash immediately. Fees charged can range from \$15 to \$30 on each \$100 advanced,² although the typical fee is at the lower end of that range. The fee may seem modest when presented as a dollar amount, but when calculated as an annual percentage rate (APR),³ the cost is relatively high. A charge of \$15 to borrow \$100 for 14 days amounts to an APR of 391%. A survey by consumer advocates found APRs on 14-day payday loans ranging from 390% to 871%.⁴

A loan can become even more expensive for the borrower who does not have the funds to repay the loan at the end of two weeks and obtains a rollover or loan extension. An additional fee is attached each time the loan is extended through a rollover transaction. If a payday loan of \$100 for 14 days with a fee of \$15 were rolled over three times, it would cost the borrower \$60 to borrow \$100 for 56 days. While this is still an APR of 391%, this example demonstrates how the loan fees can quickly mount and could eventually become greater than the amount actually borrowed. Consumers can also become trapped in back-to-back transactions. In these cases, the customer pays off the first loan but immediately borrows again to meet financial needs. If the borrower defaults on the loan, serious financial consequences can occur. The lender can deposit the customer's personal check which would result in additional fees (from the bank) for insufficient funds if it did not clear the borrower's checking account and could result in the consumer being identified as a writer of bad checks.

Payday lenders found a significant demand for these small loans from customers who found themselves unable to meet their current living expenses. These borrowers would have personal checking accounts but no "cushion" of savings to meet unexpected expenses or financial emergencies. In addition, they might not have easy access to credit elsewhere; for example they may not qualify for a low interest credit card or they may have found that their bank does not offer loans for small amounts of credit. Payday lenders do not check a borrower's credit history or look into his or her ability to repay the loan. They only require identification, proof of income, and ownership of a checking account.

Critics of payday lenders consider payday loans to be abusive in their terms and in relation to a borrower's ability to pay. Consumer advocates argue that the industry targets vulnerable consumers, that the practice encourages chronic borrowing, and that frequent

¹ "Fast Cash is Gaining Currency," *The Dallas Morning News*, Jan. 4, 2005.

² *No Cash 'til Payday: The Payday Lending Industry*, Federal Reserve Bank of Philadelphia-Supervision, Regulation, and Credit, First Quarter 2002, p.2.

³ The APR is a standard measurement of cost of credit to a borrower.

⁴ *Show Me The Money: A Survey of Payday Lenders*, State Public Interest Groups (PIRGs) and the Consumer Federation of America, Feb. 2000, p.1.

users can become trapped in a cycle of expensive debt. Proponents state that payday loans are meeting a need for short-term or emergency credit that is not being met by traditional financial institutions. They argue that payday loan fees can be less costly than bounced checks or credit card late fees and interest charges.

In general, state laws govern payday lending. State laws are not uniform in their treatment of payday lending. Currently, 15 states do not have specific payday lending legislation or are unfavorable to the industry because of interest rate ceilings. The remaining 35 states and the District of Columbia have laws that address payday lending most of which both limit finance charges and set a maximum loan amount.⁵ Some payday lenders sought arrangements or partnerships with banks and thrifts⁶ that might allow them to circumvent state restrictions or prohibitions. Consumer advocates spoke out against this practice, calling it rent-a-bank payday lending.

A trade association for the payday loan industry created a set of standards for its membership. The Community Financial Services Association of America (CFSA) adopted a set of guidelines called Best Practices⁷ in 2000. The standards apply only to members and do not have the force of law.

Federal Regulatory Response

By the late 1990's, consumer advocates were asking federal regulators, state legislators, and Congress to address what they viewed as inadequate consumer protections for the rapidly expanding operations of payday lenders. Some called for an outright ban against payday loans while others argued for restrictions, increased disclosure, and consumer education. Contractual arrangements between depository financial institutions and payday lenders raised additional concerns for the federal regulators of banks and thrifts.

On March 24, 2000, the Board of Governors of the Federal Reserve System published a rule that added a section to the staff commentary on Regulation Z, the Truth in Lending Act (TILA). The TILA requires creditors to disclose the cost of credit as a dollar amount and in terms of the APR. The commentary revision⁸ clarified that payday loans are within the definition of credit in the TILA and, therefore, payday lenders are required to provide the standard disclosures. Before the rule was issued some payday lenders had stated that their cash advances to customers were not extensions of credit and, therefore, should not be subject to the TILA.

Payday lenders drew the attention of the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS), and the Federal Deposit Insurance Corporation (FDIC) when they sought arrangements with banks and thrifts to expand

⁵ Information on state laws was found on the National Conference of State Legislatures website, [<http://www.ncsl.org>].

⁶ In this report the term *thrift* refers to savings banks and savings and loan associations .

⁷ To view the Best Practices standards go to the CFSA website at [<http://www.cfsa.net>].

⁸ 12 C.F.R. Part 226.2(a)(14).

payday lending activities. These arrangements could be structured to include marketing, servicing, and financing activities. The involvement of banks and thrifts might be sought in an effort to avoid the state and local laws that would restrict the operations of payday lenders. Certain federal preemptions of state law are granted by regulators to banks and savings associations,⁹ so a partnership could facilitate the payday lender's circumvention of a state's usury laws or other restrictions. The terms of individual agreements vary. In an example situation, the payday lender would use a bank to initially fund loans originated through the lender and then the bank would sell the loans back to the payday lender. The payday lender would then service the loans and collect the payments.

Federal regulators responded to payday lender efforts by issuing advisory letters and guidelines regarding contractual arrangements with nonbank, third-party vendors (payday lenders) to fund payday loans. On November 27, 2000, the regulator for national banks (the OCC) and the regulator for federal and state-chartered thrifts (the OTS) issued advisory letters and supervisory guidelines relating to payday loans.¹⁰ The regulators stated that payday loans were one example of a type of product being developed by non-bank vendors that raised supervisory concerns because of the efforts by some vendors to engage national banks and thrifts as delivery vehicles.

The joint statement by the regulators outlined several specific concerns. Consumer protection concerns were raised because of loan terms and borrower characteristics. The statement referred to non-bank vendors seeking to avoid individual state laws. The regulators were concerned that the bank or thrift would not be significantly involved in the marketing of the product. The institution might have an insignificant economic interest in the business generated by the vendor and may not be able to properly oversee the vendor's operations. Concern was expressed that many vendors of these products engaged in practices that may be viewed as abusive to consumers.

The regulators cautioned institutions about risks and safety and soundness threats. Guidance issued by the OCC and the OTS highlighted the significant risks associated with payday lending. Five categories of risk were analyzed; credit, counterparty (contractual), transaction (operational), reputation, and compliance and legal risks.

The two regulators stated that individual institution management should carefully weigh the possible ramifications of payday lending and should consult with their legal counsel and regulators before pursuing payday lending. The regulators stated their intent to scrutinize any such arrangements and to use their supervisory authority to examine the operations of non-bank vendors.

The regulators also acknowledged that payday loans were responding to a consumer demand for short-term, low-balance credit. They encouraged banks and thrifts to consider

⁹ For more information on federal preemption, see CRS Report RL32197, *Preemption of State Law for National Banks and Their Subsidiaries by the Office of the Comptroller of the Currency*, by M. Maureen Murphy.

¹⁰ The full text of the advisory letter and supervisory guidance can be found on the OCC website at [<http://www.occ.treas.gov/ftp/advisory/2000-10.txt>] and the OTS website at [<http://www.ots.treas.gov/docs/7/77099.html>].

how this need could be served in a safe and sound manner, including the development of alternative financial products.

On November 2, 2001, the OCC issued further guidance on the risks arising from third-party relationships (including payday lenders) in an OCC bulletin.¹¹ The OCC warned that third-party activity should be conducted in a safe and sound manner and in compliance with applicable laws. The bulletin stated that the OCC would scrutinize any arrangement. The Comptroller of the Currency has also made public statements directing banks to avoid involvement with payday lending.

Enforcement actions have been taken by both the OCC and the OTS to halt payday lender relationships with institutions they supervise. To date, the OTS has intervened with two arrangements and the OCC with four. Consumer advocates state that a clear signal has been sent by these two regulators to the institutions they supervise to stay away from partnerships with payday lenders.

The FDIC is the primary supervisor for state-chartered banks that are not members of the Federal Reserve System. On July 2, 2003, the FDIC responded to concerns raised by banks becoming involved with payday lending by issuing examination guidance for FDIC supervised institutions that participate in payday loans.¹² The guidance warned of safety and soundness issues. The guidance discussed the high risk nature of payday lending and referred to the five categories of risk addressed by the OCC and OTS. The FDIC's guidance may allow banks to participate in payday lending if strict requirements and standards are met. The guidance instructs examiners to consider a comprehensive range of regulatory factors when inspecting banks that do opt to be involved in these arrangements. Factors include concentrations of credit, capital adequacy, loan loss provisioning, and policies towards rollovers. The guidelines are to be applied during the regular bank examination schedule.

In September 2004, consumer advocates testified¹³ that the FDIC guidelines are not sufficiently stringent and that their enforcement may not provide needed consumer protections. Ten state-chartered FDIC supervised banks were listed that had partnered with payday lenders. Congress was urged to prohibit the use of checks drawn on banks and thrifts as the basis for loans.

On March 1, 2005, the FDIC issued revised examination guidance on payday lending programs. The FDIC expressed concerns about the manner in which payday lending was being conducted. The revised guidance states that institutions should ensure that payday loans are not provided to customers who have had payday loans outstanding from any

¹¹ The full text of OCC Bulletin 2001-47 can be found on the OCC website [<http://www.occ.treas.gov/ftp/bulletin/2001-47.doc>].

¹² The full text of the guidance can be found on the FDIC website at [<http://www.fdic.gov/news/news/press/2003/pr7003.html>].

¹³ Testimony of Jean Ann Fox, in U.S. Congress, House, Committee on Financial Institutions Subcommittee on Financial Institutions and Consumer Credit, *Financial Services Issues: A Consumer's Perspective*, Sept. 15, 2004.

lender for a total of three months in the previous 12-month period.¹⁴ Customers turned down for payday loans should be provided with information on alternative credit products. In addition, FDIC-supervised banks active in payday lending were instructed to submit their plans addressing the revised guidance.

On March 11, 2005, the FDIC issued a cease and desist order against a state-chartered bank that affiliates with payday lenders. The regulator ordered the bank to make several improvements related to its payday lending activities.

Legislation

The operation of the payday loan industry and the criticism of this financial product has raised congressional concerns. In the 109th Congress, two bills (H.R. 1643 and H.R. 1660) addressing payday lending have been introduced. H.R. 1660 would restrict the operations of payday lenders, regulate the involvement of banks and thrifts, and set minimum national standards for state payday loan laws. H.R. 1643 amends a variety of banking laws to protect borrowers from loans that in their terms and relation to a borrower's ability to pay may be abusive. Section 6 of H.R. 1643 amends the TILA. The new provisions would limit rollovers or loan extensions and provide consumers with additional disclosure concerning the hazards of payday lending. Both bills were introduced on April 14, 2005, and no further action has been taken on either.

¹⁴ The full text of Financial Institution Letter FIL-14-2005 can be found on the FDIC website [<http://www.fdic.gov/news/news/financial/2005/fil1405.pdf>].