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This document and any attachments are superseded by (AL 2000-10).

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MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Richard M. Riccobono

SUBJECT: Payday Lending

Summary

The Office of Thrift Supervision (OTS) is issuing this memorandum to ensure safe and sound lending practices, and to highlight and discourage any abusive practices associated with payday lending. Payday loans are small-dollar, short-term loans that borrowers promise to repay out of their next paycheck. These loans typically have high fees and interest rates, and are also refinanced frequently. After several such refinancings over a short period of time, borrowers may find themselves owing many times the amount they originally borrowed.

The proliferation of payday lending indicates a significant demand for short-term credit to manage the cash flow problems of people of lower incomes – but who have checking accounts and steady jobs. OTS strongly encourages institutions to reach out to these customers and provide responsible services for their legitimate needs. However, OTS has a variety of safety and soundness, compliance, and consumer protection concerns regarding payday lending programs. OTS will closely review the activities of savings associations engaged in this type of lending. When the institution is not following prudent lending practices or when examiners consider the institution's lending practices to be abusive, OTS will initiate corrective measures, including enforcement actions when appropriate. Many of the principles discussed in this memorandum are broadly applicable to other similar lending activities.

Background

As an example of a typical payday loan transaction, assume a consumer needs to borrow $100 until his or her next payday. The lender makes the loan for a term of two weeks and charges a fee that is often financed into the loan. For this example, assume the fee is $15. The lender requires the borrower to give it a post-dated check for $115, which it agrees to hold until the borrower's next payday. When the loan comes due, the borrower may allow the check to be cashed, redeem it by bringing in the full $115 in cash, or "roll it over" by taking out another loan and paying an additional $15 for another two weeks.

As borrowers often find themselves short of funds again on the loan's due date, they need to refinance the loan. If the consumer rolls over the loan just three times, the finance charges quickly rise to $60 to borrow $100. Many borrowers refinance their loans multiple times. The loan set up or refinance fees can be much higher than the $15 example. OTS is aware of one lender that charged a $75 fee to refinance a $250 loan. Because these loans have such short terms to maturity, the cost of borrowing, expressed as an annual percentage rate (APR), is very high. In the $75 fee example, the lender disclosed a 781% APR to the borrower on its Truth in Lending (Regulation Z) disclosure forms.

Although a loan's APR must be disclosed to the borrower, lower-income borrowers, who are the most frequent users of these types of loans, do not appear to be deterred by the fact that the interest rate or fees on these loans are inordinately high. Apparently, their immediate financial needs cause them to be willing to pay large fees to obtain short-term loans. Some borrowers also may have had problems with other loans and, when faced with an emergency, believe they have no other options. Others may not fully understand the negative effect high cost borrowing will have on their financial well-being.

OTS acknowledges that lending to borrowers with past credit problems serves a valid need. However, such lending may entail more risk than lending to borrowers with good credit histories. Lenders must charge higher rates and fees to offset higher proportional processing costs (due to lower loan size), collection costs, and loan losses. Nevertheless, the pricing of some of these loan products goes well beyond what is normal or fair, and, in some cases, particularly when the rollover usage pattern is taken into account, appears abusive. Such practices are not appropriate for savings associations or their subsidiaries. Payday lenders that seek to affiliate with federal thrifts should not assume that the benefits of a federal charter, particularly in preemption of state and local law, will be available.

While the number is few, OTS is aware that some institutions offer these or similar products. Moreover, some unregulated institutions are originating such loans for thrift institutions. Given our concerns, this memorandum highlights the significant risks associated with payday lending.

Significant Risks

Payday lending programs involve lending practices that may be abusive. In addition, payday lending carries significant credit, counterparty, operational, reputation, and compliance or legal risks that raise supervisory concerns. Institutions must ensure that these risks are adequately measured, monitored and controlled on a ongoing basis. These risks are discussed below:

Credit Risk - Borrowers targeted by abusive loan practices are often low-income individuals who have an immediate financial need to get through an emergency or unexpected expense. These borrowers frequently have blemished credit that further limits their access to other forms of credit at a reasonable cost. The combination of these borrower characteristics and the unsecured nature of the loan present significant credit risk. These loans are often considered subprime and the credit risks they present must be controlled by institution management as discussed in the Interagency Guidance on Subprime Lending (March 1,

RESCINDED

1999) and the Interagency Uniform Retail Credit Classification and Account Management Policy (May 10, 1999).[1]

The short-term nature of the loans also adds to the credit risk since the borrower is typically obligated to pay the full amount of principal and fees within a short period of time, usually two weeks (unless renewed). The high payment results in a very high renewal rate with little or no principal reduction. This may mask the true collectibility of these loans and the quality of the portfolio. As defaults occur, the institution may not be able to recover the small balance loans at a reasonable cost in relation to the loan size, thus necessitating a more aggressive charge-off policy.

Institutions must have adequate internal controls in place to ensure that policies and procedures governing payday loans are prudent and adequately followed. The institution's board of directors should be provided periodic reports, including volume, delinquency, performance, audit, and compliance reports on payday lending activities. The board of directors should establish reasonable and prudent concentration limits for this activity.

As with all lending, institutions should not make payday loans without reasonable expectation of repayment in a timely manner. Prudent limits should be established on the requirements for and number of times payday loans can be rolled over. Moreover, the institution's analysis supporting the borrower's ability to repay should entail information about the borrower's employment or other sources of income. No more than one payday loan to a borrower should be outstanding at a time.

The institution should also ensure that effective collection facilities are in place. If collection is performed by a third party, the institution should closely monitor those collection activities to ensure that they are adequate and comply with applicable consumer protection laws and regulations. Moreover, when an institution purchases payday loans, such arrangements must comply with the lending limitations of 12 C.F.R. 560.93, when applicable. For example, if the loans are sold with recourse or guaranteed they may be subject to the loans-to-one-borrower limits.

Finally, institutions must maintain additional capital and allowances for loan and lease losses (ALLL) commensurate with the added credit and other risks associated with their payday lending activities. The level of additional capital and ALLL required for these loans, which are typically of subprime quality, will depend on the level of such activity, the quality of the underwriting, controls, staffing over the institution's payday lending activities, and the quality and the performance of the institution's payday loan portfolio.

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[1] Institutions and their subsidiaries must apply the Uniform Retail Credit and Account Management Policy to past due loans. The policy requires that loans 90 or more days past due should be classified Substandard and loans 120 days or more past due should be classified Loss. The Policy also limits the number of times a delinquent closed-end loan can be re-aged, rewritten, or renewed to one time within a one-year period and two times within a five-year period.

RESCINDED

Counterparty Risk – Savings associations that enter into a contractual agreement with a third party expose themselves to counterparty risk. Counterparty risk is the risk that a third party may become unwilling or unable to meet the terms of a contract.

An independent agent, such as a check cashing company, acting on behalf of the institution, often originates payday loans. The independent agent may operate under an agreement with the depository institution to facilitate extensions of credit in the form of payday loans or similar short-term loans. When an institution establishes such an agreement with an independent agent, management must perform a due diligence analysis of the agent to determine its creditworthiness, reputation, and ability to meet the terms of the agreement.

The agreement must establish adequate controls over the transactions, and should clearly delineate the services to be provided by the agent, including underwriting and servicing standards, funding procedures, reporting requirements, compensation, and other terms. Institutions must ensure that the terms of the agreement provide for adequate safeguards, controls and appropriate disclosures, including APRs. In addition, institutions should conduct regular on-site transaction testing and audits of third party vendors to ensure that loans made on behalf of the institution comply with consumer protection laws and these guidelines.

While OTS may examine the systems, operations and marketing practices of such providers as they pertain to transactions with or on behalf of a savings association under 12 U.S.C. §1464(d)(7), the institution should also obtain authorization, in the agreement, for an audit or examination of the third party by OTS.

Operational Risk – Payday loans are a form of specialized lending not typically found in savings associations. 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 loans and funds between the savings association and third-party originators. Because payday loans may be underwritten off-site, there is the risk that agents or employees may misrepresent information about the loans or fail to adhere to established underwriting guidelines. Internal controls must be in place to ensure that policy guidelines governing payday loans are followed. The internal audit program should address the level of risk, and set an adequate scope to ensure controls at the savings association and the payday lender are adequate and prudently followed.

An independent agent or joint venture partnership is also frequently used to service payday loans. Information systems supplied by third parties also need to be reviewed to ensure accurate recordkeeping and system integrity. Furthermore, institutions need to thoroughly evaluate a third party service provider, and have contingency plans in place if a servicer were to fail. A thrift's failure to have a servicing contingency plan could jeopardize the collectibility of the entire portfolio of payday loans. In many cases, it is unrealistic for an institution to expect to be able to assume this responsibility itself since a typical thrift does not have the resources to service numerous accounts dispersed over a large geographic area.

Institutions should also recognize other operational risks that include the lack of collections oversight by institutions, misrepresented delinquencies or other information about the loans, lack of commitment by servicers to reduce delinquencies and non-sufficient funds accounts, and lack of trained collections personnel.

Reputation Risk - The overwhelming majority of savings institutions have exhibited a long-standing history of avoiding questionable activities that could tarnish their reputations in their communities. Due to the high fees associated with payday lending, many observers view payday lending as abusive. Where low-income groups and minorities are primarily affected by such abusive lending, negative publicity could cause the institution to lose its long-earned community support and business. To avoid jeopardizing their reputations, institutions should ensure that loan fees are reasonable, especially for loans that are frequently rolled over. In addition, institutions, or third-party vendors that institutions contract with to offer payday loans, should not layer on additional fees. For instance, consumers should not be charged fees for checks cashed as part of the payday loan process.

RESCINDED

Compliance and Legal Risk – Payday loans are subject to federal and state consumer protection and fair lending laws. Institutions that originate or purchase payday loans must take special care to ensure compliance with the relevant provisions of the Equal Credit Opportunity Act, the Truth in Lending Act (TILA), the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, and the Federal Trade Commission Act, as well as applicable provisions of state usury and deceptive practices acts. Payday lenders could be subject to class action lawsuits and litigation stemming from alleged violations of these consumer protection statutes or common law.

Insured depository institutions are responsible for the loan products they sponsor and the distribution channels they employ. Management needs to ensure that the delivery of loans does not reflect a pattern of discrimination or the targeted exploitation of unsophisticated borrowers. OTS will hold institutions accountable for the activities of others acting on behalf of the thrift in its payday operations. Therefore, an adequate compliance management program must be established to identify, monitor and control the consumer protection risks associated with the institution's payday lending programs at all points in the distribution process. Such a program needs to recognize applicable state as well as federal consumer regulations.

Management must also ensure that full disclosure regarding loan terms and fees is made to the borrower. An effective compliance management program is especially critical since the potential restitution payments required are compounded by the short-term nature of payday loans, the frequency of renewals, the volume of these loans generated monthly, and the complexity of the TILA calculations. For instance, Regulation Z provides for a five-dollar tolerance for understated finance charges in the case of small, unsecured credit extensions like payday loans, whereas Regulation Z permits a one hundred dollar tolerance for understated finance charges in the case of residential secured credit extensions. For identical dollar size portfolios, a failure to disclose a $15 finance charge could quickly result in maximum class action liability for the payday loan portfolio, but no liability in connection with the residential mortgage portfolio.

Finally, institutions should develop a process to monitor, analyze and ensure appropriate resolution of consumer complaints concerning payday loans, whether received at the institution or by third parties participating in payday transactions.

RESCINDED

New Payday Lending Arrangements

Institutions should consult with their Regional Office prior to engaging in payday lending activities. In addition, institutions are reminded that, before engaging in payday lending activities through a subsidiary, prior notification is required under 12 CFR 559.11. Furthermore, OTS has determined that such activities constitute a significant issue of policy and thus are not eligible for processing under delegated authority by the regional director. In its review of any such notice, OTS will take into account the significant risks associated with payday lending activities and arrangements with third parties described in this memorandum. OTS will also consider how the thrift will address and otherwise mitigate these risks consistent with these guidelines.

OTS Response to Payday Lending Practices

OTS will scrutinize payday lending operations and criticize those that reveal abusive lending practices or poorly managed high risk activities. OTS will also closely review any lending or financing arrangements savings associations have with payday loan companies. Depending on the nature of any such arrangement, OTS may conduct examinations of those companies.[2] Such examinations may result in OTS assessing the savings association additional fees under 12 CFR 502.60(e) for the additional costs to conduct an examination of the third party services a payday lender provides to an institution. Furthermore, OTS will bring enforcement actions to correct violations of law and regulations by the savings association or a payday lender. If OTS becomes aware that thrift institutions are engaging in abusive payday lending or do not have adequate internal controls in place to effectively manage all risks, we will consider more stringent measures to limit or curtail such practices. Such measures could include establishing regulations that limit interest rates, fees or the frequency upon which such loans can be rolled over. Nonetheless, at the current time, OTS believes the loans should not be structured to roll over the loan fees and interest, and at least a portion of principal should be paid with each renewal.

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[2] OTS will treat arrangements in which payday loan companies provide services in connection with the origination, servicing, and collection of payday loans on behalf of savings associations as subject to the provisions granted by the Examination Parity and Year 2000 Readiness for Financial Institutions Act (Pub. L. No. 106-164 enacted March 20, 1998, 12 U.S.C. 1464(d)(7)(D)). Therefore, the performance of the third party in connection with the arrangement will be subject to examination by OTS to the same extent as if the institution itself was performing such services. This does not, however, include examination of activities of a provider that do not involve the savings association or the general financial and legal condition of the third party provider.

Conclusion

Because of the concerns noted, OTS advises against institutions establishing or participating in lending programs that are not in the best interest of both the institution and its customers. OTS does, however, continue to support *bona fide* lending activities to low-to-moderate income or credit impaired individuals that are in the best interests of the institution and its customers. OTS encourages thrifts to develop and deliver sound banking products that suit legitimate consumer financial needs and foster improved choice for under-served markets. In this way, insured depository institutions can bring more people into the safety of the American banking system and help eradicate the exploitive and abusive practices to which many consumers are subjected. OTS also supports industry efforts to promote the use of industry best practices when engaged in payday lending. As always, institutions must follow sound lending practices, manage their lending risks, and be mindful of the burden the loan will place on their customers.

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