OCC ADVISORY LETTER

Comptroller of the Currency
Administrator of National Banks

Subject: Payday Lending

TO: Chief Executive Officers of All National Banks, Department and Division Heads, and All Examining Personnel

PURPOSE

The Office of the Comptroller of the Currency (OCC) is issuing this advisory letter to ensure that any national bank that engages in payday lending does so in a safe and sound manner and does not engage in abusive practices that would increase the compliance, legal, and reputation risks associated with payday lending and could harm the bank's customers.

"Payday loans" (also known as "deferred deposit advances") are small-dollar, short-term loans that borrowers promise to repay out of their next paycheck or deposit of funds. These loans typically have high fees, are often renewed frequently, and, in the case of some lenders or originators, may involve abusive lending practices, such as the use of threats of criminal prosecution in loan collection. OCC Advisory Letter 2000-7, issued July 25, 2000, alerted national banks to the increased compliance, fair lending and credit risks associated with abusive or predatory lending practices.

Although the OCC encourages banks to respond to customers' short-term credit needs, payday lending can pose a variety of safety and soundness, compliance, consumer protection, and other risks to banks. In addition, some national banks have entered into arrangements with third parties in which the national bank funds payday loans originated through the third party. In these arrangements, national banks often rely on the third party to provide services that the bank would normally provide itself. These arrangements may also involve the sale to the third party of the loans or the servicing rights to the loans. Such third-party arrangements significantly increase risks to the bank and the OCC's supervisory concerns. OCC Advisory Letter 2000-9, issued August 29, 2000, described the risks associated with engaging in certain credit-related activities with third parties. 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.

The OCC will closely review the activities of national banks engaged or proposing to engage in payday lending, through direct examination of the bank, examination of any third party participating in the transaction under an arrangement described above, and, where applicable, review of any licensing proposals involving this activity. These examinations will focus not only on safety and soundness risks, but also on compliance with applicable consumer protection and fair lending laws. In addition, the OCC may assess special examination fees on banks to cover the OCC's additional costs of conducting an examination or investigation of third parties that provide payday lending services to the bank. When the bank is not following prudent lending practices or when examiners consider the bank's lending practices to be abusive, the OCC will initiate corrective measures, including enforcement actions when appropriate.

BACKGROUND

Payday lending is a type of short-term credit that is often used by consumers with regular paychecks and bank accounts to meet unexpected financial emergencies or other temporary cash flow needs, or as an alternative to overdraft or credit card lines of credit. These loans are often priced at a fixed dollar fee, or a percentage of the loan amount, which, when annualized, produces a very high annual percentage rate (APR). Because of financial circumstances and needs, some borrowers are not deterred by the high APR that is disclosed; nor, for the same reason, do they pursue alternative, less expensive sources of credit. While they are expensive as short-term credit, payday loans that are renewed multiple times can be an exceedingly expensive form of borrowing that may be unsuitable for some borrowers over the long term.

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 $15 fee. As part of the transaction, the lender will require the borrower to give it a postdated check for $115 (or for $100, if the borrower pays the $15 fee in cash) to be held until the borrower's next payday. When the loan comes due, the borrower may repay the loan by allowing the check to be cashed or by bringing in the full $115 in cash. However, the borrower may also "roll over" the loan by renewing the old loan (or taking out another loan) and giving a new postdated check either for $130 (the $115 balance due plus an additional $15 fee) or for $100 (if the fees have been paid in cash). Because payday loans have such short terms to maturity, the cost of borrowing, expressed as an APR, is very high. For example, the APR on a two-week $100 loan with a $15 lender fee is 391 percent.

Some payday lenders have been criticized for such things as failure to properly disclose the costs of the loan; failure to ascertain whether the borrower is in a position to repay the loan in accordance with its terms; unlimited and costly renewals of the initial loan that perpetuate indebtedness; and the use of intimidation and unwarranted threats of criminal prosecution in loan collection.

To address these potential abuses, some payday lenders have adopted the following program features:

- Strict limitations on "rollovers"
- Strict limitations on the number of payday loans that any borrower may have in a year
- Substantial waiting periods between loans
- Right to rescind a loan without charge within 24 hours after it is made
- Prohibition on fees to cash a check used to repay the loan
- Clear and understandable disclosures concerning the costs and risks associated with payday loans

In addition, some banks offer affordable substitutes for payday loans by linking low-cost electronic accounts that have overdraft features with direct deposit arrangements. For example, under one program, depositors with direct deposit arrangements may obtain overdraft protection—with the overdraft to be repaid from the customer's next electronic payroll deposit—at a cost substantially lower than that typically offered by nonbank payday lenders.

Given our concerns about payday lending activities, this advisory letter highlights the significant safety and soundness and other risks associated with payday lending and provides guidelines for addressing these risks.

RISK ANALYSIS

Payday lending programs, as offered by some lenders or originators, may involve lending practices that are abusive. In addition, payday lending carries significant credit, transaction, reputation, and compliance and legal risks that raise supervisory concerns. These risks are discussed below:

Credit Risk

- Borrowers who obtain payday loans frequently have limited financial capacity or blemished or insufficient credit histories that limit their access to other forms of credit at a reasonable cost. Payday loans that are considered subprime loans are subject to specific credit and other risks identified in the interagency and OCC guidelines on subprime lending (see OCC Bulletins 99-10, issued March 5, 1999, and 99-15, issued April 5, 1999).

- Unlimited renewals, multiple renewals without principal reduction, or renewals in which interest and fees are added to the principal balance are not consistent with safe and sound banking principles. Payday loans that remain on the bank's books are subject to the Uniform Retail Credit Classification and Account Management Policy, which establishes parameters for renewing credits. Under the policy, a bank must adopt explicit standards that control the use of renewals, and the standards must be based on the borrower's willingness and ability to repay the loan. Payday lending that is not subject to appropriate limitations on the number and frequency of renewals would not meet the intent and standards of the policy.

- Contractual agreements with third parties that originate, purchase, or service payday loans may increase the bank's credit risk due to the third party's inability or unwillingness to meet the terms of the contract. As noted in OCC Advisory Letter 2000-9, the risks from such third party arrangement "can be excessive if management and directors do not exercise appropriate due diligence prior to entering the third pary arrangement, and effective oversight and controls afterwards." Furthermore, a bank needs to have contingency plans in place if a third party servicing the loans were to fail. The risk from the third party's failure to meet the terms of the contract also results in increased compliance, reputation, and legal risk.

Transaction Risk

- Payday loans are a form of specialized lending not typically found in national banks, but are frequently originated by unregulated nonbank firms. 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 national bank and any 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 increase credit risk by failing to adhere to established underwriting guidelines.

Reputation Risk

- Due to the high fees and other characteristics associated with some payday lending programs, many believe payday lending to involve abusive lending practices, such as the use of threats of criminal prosecution in loan collection. Engaging in these practices could increase the reputation risk for a national bank and cause it to lose community support and business. In addition, banks face increased reputation risk when they enter into arrangements with third parties to offer payday loans with fees, interest rates, or other terms that could not be offered by the third party directly.

Compliance and Legal Risks

Banks that originate or purchase payday loans must take special care to avoid violating fair lending and consumer protection laws and regulations. Failure to comply with statutory and regulatory requirements may lead to various administrative actions, including enforcement actions to address violations and to ensure appropriate corrective action; lawsuits; and civil penalties. For example:

- *Equal Credit Opportunity Act* (ECOA): High fees associated with payday loans, combined with possible compensation incentives, may foster abusive pricing or discriminatory steering of borrowers to high cost payday loans. In addition to ensuring nondiscriminatory lending, the *bank*, as creditor, is responsible for complying with the Regulation B requirements concerning notifying an applicant of action taken on a loan application and providing the reasons for adverse action. Further, if credit-scoring systems are used to evaluate borrowers' applications for payday lending products, a bank must ensure that such systems comply with applicable Regulation B requirements for system revalidation, and, if overrides are allowed, that they are based on nondiscriminatory factors.

- *Truth in Lending Act* (TILA): A bank that is engaged in payday lending must ensure that accurate TILA disclosures are provided to customers. If the bank provides payday loans through a third-party arrangement, the *bank*, as creditor, is responsible for accurate and timely TILA disclosures. A bank that fails to disclose finance charges and APRs accurately—taking into account the small dollar tolerance for inaccuracies—risks having to pay restitution to consumers, which, in some instances, may be significant. A bank would also violate TILA by advertising terms that are not actually available.

- *Fair Credit Reporting Act*: A bank engaged directly or indirectly in payday lending is responsible for complying with requirements to provide adverse action notices to consumers when it declines an application for credit based on certain information. In addition, if adverse action is taken based on information received from a third party that is not a consumer reporting agency, the adverse action notice must direct the consumer to the *bank*, and not any third party, for details regarding the character of the information (even where the payday loan applications are received by the bank through a third party).

- *Fair Debt Collection Practices Act* (FDCPA) and *Federal Trade Commission Act* (FTC Act): If a bank engages in payday lending through an arrangement with a third party, and the third party regularly collects defaulted debts on behalf of the bank, the third party would be subject to the provisions of the FDCPA. Although the bank itself may not be subject to the FDCPA, it nevertheless faces significant reputation risk—and potential legal risk for approving or assisting in an unfair or deceptive trade practice in violation of the FTC Act—if the third party violates the FDCPA and engages in deception, harassment, or threats in the collection of the bank's loans.

- *Lending Limits*: In cases where a bank purchases payday loans from a third party, such as a broker or joint venture partner, who continues to service the loans, the aggregate of such loans may be subject to the lending limitations of 12 CFR Part 32.

- *Electronic Fund Transfer Act and Truth in Savings Act*: A bank may establish a payday lending program in which it opens a deposit account for each payday loan customer, deposits the loan proceeds into the account, and issues an access device to debit funds from the account. The disclosure and other requirements of both the Electronic Fund Transfer Act and the Truth in Savings Act will apply to such programs.

BANK SERVICE COMPANY ACT AND OTHER SUPERVISORY CONCERNS

In some situations, an independent agent, such as a check cashing company, acting on behalf of the bank, may provide services in connection with originating and collecting payday loans. The independent agent may operate under an agreement with the depository institution to originate or facilitate extensions of credit in the form of payday loans or similar short-term loans.

The OCC will closely review any payday lending activities conducted directly by national banks, as well as any payday lending or financing activities conducted through arrangements with third parties. The OCC will treat arrangements in which third parties provide services in connection with the origination, servicing, and collection of payday loans made by national banks as subject to the provisions of the Bank Service Company Act, 12 USC 1867(c). Therefore, the OCC may examine the performance of these services by the third party to the same extent as if the bank itself were performing these services on its own premises. Such examinations would evaluate safety and soundness risks, compliance with applicable consumer protection and fair lending laws, and whether the third party engages in unfair or deceptive acts or practices in violation of federal or applicable state law. In addition, the OCC will pursue appropriate corrective measures, including enforcement actions, to address violations of law and regulations or unsafe or unsound banking practices by the national bank or the third party.

Concurrently with the issuance of this advisory letter, the OCC is publishing in the *Federal Register* a proposal to amend its regulation on assessment of fees (12 CFR Part 8) to clarify that the OCC may assess a national bank a special examination or investigation fee when the OCC examines or investigates the activities of a third-party service provider. The OCC will conduct such special examinations or investigations if the activities conducted by the service provider for the bank present heightened risks or are of an unusual or novel nature, or when the bank has insufficient systems, controls, or personnel to adequately monitor, measure, and control the risks associated with the activity. Due to the significant level of risks to the bank posed by certain payday lending programs, the OCC may assess national banks for conducting special examinations or investigations of third-party payday loan service providers.

LICENSING CONSIDERATIONS

The OCC will scrutinize carefully any proposals submitted by national banks or organizers that intend to originate payday loans, whether in a new charter, through investments in third parties, or through subsidiaries. The OCC will require an application to be submitted for any proposed investment in a company engaged in payday lending. If a national bank proposes to enter into an arrangement with a third party in connection with payday lending that will involve the bank's subsidiary, the OCC deems that arrangement to be a new activity by the subsidiary for which an application is required. The activity is not eligible for an after-the-fact notice. In its review of, and decision on, any such application, the OCC will take into account the significant risks associated with payday lending activities and arrangements with third parties described in this letter. The OCC will also take into consideration how the bank will address and otherwise mitigate these risks consistent with the following guidelines.

GUIDELINES FOR ADDRESSING SAFETY AND SOUNDNESS, REPUTATION, COMPLIANCE AND LEGAL RISKS ASSOCIATED WITH PAYDAY LENDING

Banks must follow sound lending practices, manage their lending risks, and be mindful of the burden the loan will place on their customers. Banks should ensure that they adhere to the following criteria designed to minimize safety and soundness, reputation, compliance and legal risks associated with payday lending:

- A bank should follow the Interagency Guidelines on Subprime Lending, the Interagency Uniform Retail Credit Classification and Account Management Policy, and OCC Advisory Letters 2000-9 (addressing third-party risk) and 2000-7 (addressing abusive lending practices).

- A bank should establish policies and procedures to identify, routinely monitor and control the credit, transaction, reputation, compliance and legal risks associated with the bank's payday loan programs. Any payday lending policies and procedures should also address applicable consumer protection and fair lending laws and regulations. Lending officers and any third parties acting on behalf of the bank should be trained in the specific compliance policies and procedures and risks concerning the payday loan product.

- If payday lending is done indirectly through a third party, the agreement between the bank and a third party must establish adequate controls over the loan transactions, and should clearly delineate the services to be provided by the third party, including compliance with the bank's underwriting and servicing standards, funding procedures, reporting requirements, compensation, and other terms.

- A bank should monitor the collection activities, including collection calls, of any third party on behalf of the bank.

- A bank should conduct on-site transaction testing and other audits of third party vendors with whom it has arrangements to offer payday loans for compliance with consumer protection laws and these risk guidelines.

- A bank should develop a process to monitor, analyze, and ensure appropriate resolution of consumer complaints concerning payday loans, whether received at the bank or by a third party participating in the transaction.

- A bank's board of directors should be provided periodic reports, including compliance reports and audit reports, on the bank's payday lending activities.

- Because of the credit and other risk characteristics of payday loans, a bank also should limit its concentration risk by not investing an undue percentage of its capital in payday loans it originates or retains on its books.

- As with all lending, a bank should not make a payday loan without a reasonable assurance that the loan will be repaid at maturity. At a minimum, such assurance must entail analysis of information about the borrower's continued employment or other recurrent source of income, or the borrower's reasonable expectation that additional income or other deposit will be received on a date certain and that such income or deposit will retire the loan.

- A bank should ensure that no more than one payday loan is outstanding with the bank at a time to any one borrower.

- As a matter of observing "best practices," a bank should consider offering each payday loan borrower a one-business-day cancellation period during which he or she may return with good, collected funds (cash, cashier's check, acceptable money order, or money transfer) to repay the loan and receive a full refund of the fee.

- A bank should ensure that a third-party vendor with whom it has an arrangement to offer payday loans does not impose a check-cashing fee for the check written as part of the payday loan origination process.

- A bank should not renew a payday loan except upon a written request by the borrower that certifies an inability to repay the loan, states a specific reason that occurred subsequent to the date of origination or last renewal, and states why the borrower will be able to repay the loan at the new maturity date. Multiple renewals—particularly renewals without a reduction in the principal balance, and renewals in which interest and fees are added to the principal balance, are an indication that a loan has been made without a reasonable expectation of repayment at maturity.

- A bank should provide each payday loan borrower a disclosure statement that complies with TILA and other applicable disclosure laws. In addition, a bank should provide each payday loan borrower with written disclosures, before such loan is made, that inform the borrower

    - of all loan terms and fees (including any applicable ATM fees) associated with the loan;
    - of the risks and potential problems of short-term borrowings and the consequences of abuse;
    - that alternative forms of short-term credit exist that might be less expensive and more suitable and advantageous to the borrower; and
    - of the full cost of a hypothetical transaction that involves multiple renewals in accordance with these criteria, and the possible consequences of allowing the check to bounce, including the imposition of fees for insufficient funds from the borrower's own bank and the payday lender, and the loss of checking account privileges, if applicable.

    Such disclosures should be reasonably understandable and designed to call attention to the nature and significance of the information.

Because of the significant risks involved, national banks should consult their supervisory office before committing to *any* arrangements described in this advisory letter or engaging in payday lending activities. Questions concerning this advisory letter may be directed to the Community and Consumer Law Division at (202) 874-5750, or the Credit Risk Division at (202) 874-5170.

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