Prudential Regulators Should Apply Safety and Soundness Standards to Bank Payday Loan Products

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Applying safety and soundness standards to bank payday loan products follows longstanding principles and policy of the prudential regulators. Consistently, the prudential regulators, including the OCC, FDIC and the Federal Reserve, have addressed problems with a variety of consumer lending products by citing not only consumer protection concerns, but also safety and soundness concerns, even when those products are very profitable for the bank. Examples include:

- 2001 joint guidance on subprime lending, applicable to all consumer lending products;
- 2000 OCC and 2003 FRB enforcement actions addressing fee harvester credit card practices;
- Guidance addressing payday lending, including payday lending directly by banks:
    - 2000 OCC guidance on third party and bank payday lending;
    - 2005 FDIC guidance on third party and bank payday lending;
    - 2011 OCC proposed guidance on bank payday lending;
- 2005 joint guidance on overdraft programs; and
- 2007 joint guidance on subprime mortgage lending.

As discussed further in this memo, bank payday lending shares key troubling characteristics of all the products addressed above and should, likewise, be addressed by prudential regulators based on both consumer protection and safety and soundness concerns.

<u>Prudential regulators have consistently used safety and soundness authority in supervising bank payday loans and similar products.</u>

- **In 2001, the agencies issued joint guidance on subprime consumer lending products.[1] In this guidance, the agencies emphasized that banks need to base lending on determination of the borrower's ability to repay the loan, as opposed to relying on collateral, and that the failure to underwrite the loan was a safety and soundness concern:**

    - "Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound. Such lending practices should be criticized in the Report of Examination as imprudent. Further, examiners should refer any loans with the aforementioned characteristics to their Agency's respective consumer compliance/fair lending specialists for additional review."[2]

    - This guidance was applicable to subprime consumer lending generally, beyond the mortgage context, and the FDIC has cited its specific relevance to payday lending.[3]

    - Bank payday loans violate this fundamental rule of sound underwriting.

- **Both the OCC and the Federal Reserve Board have taken enforcement actions against subprime fee harvester credit card companies, citing safety and soundness concerns as well as unfair and deceptive practices, even as the companies were recording record profits generated by these products:[4]**

    - **OCC action against Providian:**

        - In 2000, the OCC took enforcement action against Providian, requiring that it pay customers at least $300 million in the agency's largest ever enforcement action at the time.[5]

        - Comptroller John Hawke stated: "'When a bank engages in unfair or deceptive marketing practices, it damages its most precious asset –the trust and confidence of its customers . . . . That relationship of trust and confidence is central to the bank's safe and sound operation. We will not tolerate abuses that breach that trust through unfair and deceptive practices."

          "This settlement . . . ensures that, going forward, Providian will conduct its business in a way that both respects the interests of its customers and protects the safety and soundness of the bank."'[6]

    - **FRB action against First Premier:**

        - In 2003, the Federal Reserve Board took enforcement action against First Premier on safety and soundness grounds, while noting that the bank must comply with the Board's applicable guidance related to subprime lending.[7]

        - Fee harvester practices share stark similarities with bank payday loans—they are profitable to the bank, but largely because they trap borrowers in debt.[8] They are also both structured so that the borrower quickly pays the bank more in fees than the amount of credit extended, limiting the possibility of credit loss.

- **The 2000 OCC advisory letter addressing payday lending,[9] the FDIC 2005 payday lending guidance,[10] and the 2011 OCC proposed guidance addressing deposit-related credit products,[11] are all based primarily on safety and soundness concerns.**

    - **2000 OCC advisory letter addressing payday lending, including payday lending directly by banks:**

        - "[P]ayday lending can pose a variety of safety and soundness, compliance, consumer protection, and other risks to banks."[12]

        - "[M]ultiple renewals without principal reduction . . . are not consistent with safe and sound banking principles."[13]

        - This guidance explicitly applies to both payday lending done directly by banks and programs operated by third parties.[14]

- **2005 FDIC payday lending guidance, including payday lending directly by banks:**
    - "This guidance provides information about payday lending, a particular type of subprime lending, and supplements and clarifies previously issued guidance about such programs, including the July 2003 Guidelines for Payday Lending. It describes safety and soundness and compliance considerations for examining and supervising state nonmember institutions that have payday lending programs."[15]
    - "Due to the heightened safety and soundness and compliance risks posed by payday lending, concurrent risk management and consumer protection examinations should be conducted absent overriding resource or scheduling problems."[16]
    - This guidance, too, explicitly applies to both payday lending done directly by banks and programs operated by third parties.[17]
- **2011 OCC proposed guidance addressing deposit-related credit products:**
    - "The Office of the Comptroller of the Currency (OCC) is proposing supervisory guidance to clarify the OCC's application of principles of safe and sound banking practices in connection with deposit-related consumer credit products such as automated overdraft protection and direct deposit advance programs."[18]
    - "This appendix describes how the OCC will apply the safety and soundness principles applicable to deposit-related consumer credit products to deposit advance products."[19]

- **In the 2005 joint guidance on overdraft products,[20] the agencies found that these extensions of credit raised substantial safety and soundness, as well as consumer protection, issues:**
    - "Safety & Soundness Considerations . . . .
      When overdrafts are paid, credit is extended. Overdraft protection programs may expose an institution to more credit risk (e.g., higher delinquencies and losses) than overdraft lines of credit and other traditional overdraft protection options to the extent these programs lack individual account underwriting. All overdrafts, whether or not subject to an overdraft protection program, are subject to the safety and soundness considerations contained in this section."[21]

      The guidance then sets out a detailed and extensive discussion of safety and soundness concerns.[22]
    - Since federal regulators have determined that overdraft programs raise safety and soundness concerns, the same should be true for bank payday programs. Though both types of programs are highly profitable to banks, they share a lack of individual underwriting of ability to repay the loan; instead, they rely on the underlying value of incoming deposits that allow the bank to collect the loan.

- **In 2007, the agencies issued a statement on subprime mortgage lending,[23] again emphasizing, as a risk management practice, the need to assess the borrower's ability to repay the loan rather than relying predominantly on collateral:**

    - "[I]nstitutions should ensure they do not engage in . . . [m]aking loans based predominantly on the foreclosure or liquidation value of a borrower's collateral rather than on a borrower's ability to repay the mortgage according to its terms." [24]

<u>The bank payday product poses safety and soundness risks to institutions for at least the following reasons:</u>

- It exposes banks to reputational risk.

    - The FRB's supervision manual defines "reputational risk" as "the potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation, or revenue reductions."[25] All of these are significant risks with bank payday lending, including "move-your-money" actions, a class action lawsuit that has been filed against Fifth Third Bank, and the potential that regulatory action against the product (on a safety-and-soundness or a consumer protection basis) will cause banks to lose substantial revenue associated with it. In fact, FRB staff in 2007 prominently cited payday lending as an example of a product that can cause reputational risk to banks.[26]

    - Action by one or more prudential regulators without action by all prudential regulators will only escalate reputational risk for banks supervised by a regulator who fails to act.

- It exposes banks to legal risk, including UDA(A)P and ECOA violations, as typically noted in prudential regulator guidance rooted in safety and soundness. Indeed, potential violations of consumer protection laws – i.e., "*consumer protection issues*" – in and of themselves pose safety and soundness risk.[27]

- It violates the basic safety and soundness principle of underwriting based on ability to repay rather than relying on collateral.

- It encourages institutions to base their business model on revenue that may be substantially restrained in the foreseeable future by regulatory action.[28]

- It exposes institutions not offering the abusive product to safety and soundness risk, as they are at a substantial competitive disadvantage and must compete against institutions that can use high net income from the deposit advance product to cross subsidize other products.

In summary, applying safety and soundness concerns to bank payday loan products is based on well-established prudential regulator principles and precedents. The failure to do so would fundamentally violate these principles and precedents.

[1] FIL 9-2001, Interagency Expanded Guidance for Subprime Lending Programs, January 31, 2001, *available at* http://www.federalreserve.gov/boarddocs/srletters/2001/sr0104a1.pdf.

[2] *Id.* at 11.

[3] The 2001 Expanded Subprime Guidance refers to lending generally throughout and addresses consumer loans specifically ("The evaluation of consumer loans is governed by the Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) issued by the FFIEC on June 12, 2000. This policy establishes general classification thresholds based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness regardless of delinquency status."). *Id.* at 9. The guidance also contemplates equity stripping outside the context of mortgage lending, noting that lenders may make a loan to a borrower who has little or no ability to repay other than from the collateral pledged, then take possession of the borrower's home or automobile upon default." *Id.* at 10. And the FDIC's 2005 payday loan guidelines note that they clarify previously issued guidance, including this 2001 Expanded Subprime Guidance. FDIC Financial Institution Letters, Guidelines for Payday Lending, FIL 14-2005, February 2005, *available at* http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[4] *See*, *e.g.*, PR Newswire, *Providian Financial Corporation Announces Record Earnings in the Second Quarter Fueled by 50% Growth in Revenues and Customers*, July 22, 1998 (noting record earnings and projected increases going forward).

[5] OCC News Release 2000-49, *Providian to Cease Unfair Practices, Pay Consumers Minimum of $300 Million Under Settlement with OCC and San Francisco District Attorney,* June 28, 2000, *available at* http://www.occ.gov/static/news-issuances/news-releases/2000/nr-occ-2000-49.pdf.

[6] *Id.* at 1.

[7] *Written Agreement by and among United National Corporation, Sioux Falls, South Dakota; First PREMIER Bank, Sioux Falls, South Dakota; PREMIER Bankcard, Inc., Sioux Falls, South Dakota; and the Federal Reserve Bank of Minneapolis*, Federal Reserve Board, September 25, 2003, at 3, *available at* http://www.federalreserve.gov/Boarddocs/Press/enforcement/2003/20030925/attachment.pdf

[8] The founder of Providian, for example, said in 2004: "It didn't require a lot of investigation to see that the people who paid in full every month were not profitable"; the most lucrative customers were the "revolvers," who routinely carried high balances, but were unlikely to default. Robin Stein, *The Ascendancy of the Credit Card Industry*, PBS Frontline, Nov. 23, 2004, http://www.pbs.org/wgbh/pages/frontline/shows/credit/more/rise.html (quoting Andrew Kahr, founder of Providian).

[9] OCC AL 2000-10 (Nov. 27, 2000).

[10] FDIC Financial Institution Letters, Guidelines for Payday Lending, FIL 14-2005, February 2005, *available at* http://www.fdic.gov/news/news/financial/2005/fil1405a.html.

[11] Department of the Treasury, Office of the Comptroller of the Currency, Proposed Guidance on Deposit-Related Consumer Credit Products, Docket ID OCC-2011-0012, 76 Fed. Reg. 33409 (June 8, 2011).

[12] OCC AL 2000-10 (Nov. 27, 2000) at 1.

[13] *Id.* at 3.

[14] "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." *Id.* at 5.

[15] 2005 FDIC Guidelines for Payday Lending, *supra*.

[16] *Id.*

[17] *Id.* ("Examiners should apply this guidance to banks with payday lending programs that the bank administers directly or that are administered by a third party contractor.")

[18] OCC Proposed Guidance on Deposit-Related Consumer Credit Products, *supra*, 76 Fed. Reg. 33409, 33409.

[19] *Id.* at 33411.

[20] Department of the Treasury-Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Joint Guidance on Overdraft Protection Programs, 70 Fed. Reg. 9127 (Feb. 24, 2005).

[21] *Id.* at 9129.

[22] *Id.* at 9129-30.

[23] Department of the Treasury-Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, Interagency Statement on Subprime Mortgage Lending, 72 Fed. Reg. 37569 (July 10, 2007).

[24] *Id.* at 37573.

[25] Federal Reserve System's Commercial Bank Examination Manual, Examination Strategy and Risk-Focused Examinations, at 4.5 (April 2011), *available at* http://www.federalreserve.gov/boarddocs/supmanual/cbem/cbem.pdf. The OCC's supervision manual's definition is similar: "Reputation risk is the risk arising from negative public opinion. This affects the institution's ability to establish new relationships or services or continue servicing existing relationships. This risk may expose the institution to litigation, financial loss, or a decline in its customer base. Reputation risk exposure is present throughout the organization and includes the responsibility to exercise an abundance of caution in dealing with customers and the community." OCC, Bank Supervision Process, Comptroller's Handbook (September 2007) at 121, *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/banksupervisionprocess.pdf.

[26] A 2007 article on reputational risk by a FRB staff provided only a few examples of practices posing reputational risk; payday lending was one of them: "There is also a stigma attached to institutions involved with payday lending." William J. Brown, Federal Reserve Board Enforcement Specialist, *Understanding Reputational Risk: Identify, Measure, and Mitigate the Risk*, 4th Quarter 2007, *available at* http://www.phil.frb.org/bank-resources/publications/src-insights/2007/fourth-quarter/q4si1_07.cfm.

[27] *See*, *e.g*., OCC, Bank Supervision Process, Comptroller's Handbook, September 2007 (noting that consumer compliance is a subset of safety and soundness: "The OCC carries out risk-based supervision for safety and soundness purposes, including specialty areas such as consumer compliance, asset management, and information technology" (at p. 2) (emphasis added) and later noting that "[c]onsumer compliance encompasses four functional areas of consumer protection laws and regulations—fair lending, lending . . . deposits, and other consumer protection regulations" (at p. 18)).

[28] *See, e.g.,* Peter Eavis, *Providian Showing Signs Consumer Settlements Will Hurt Earnings*, The Street, June 20, 2000 (Wall Street analysts cautioning of projected reduction in earnings for Providian after news of the OCC enforcement action broke, due not only to the fine, but to "longer-term damage to profits, as [the enforcement actions] have forced Providian to jettison practices that were bringing in significant amounts of revenue").