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REGULATION AND SELF-POLICING WILL INFLUENCE CONSUMERS' ACCESS TO "PAYDAY LOANS"

by

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Charles Dickens was not thinking about payday lenders when he wrote about "the best of times" and "the worst of times," but had he been doing so, this particular turn of phrase would have accurately described the state of the payday lending industry today. From its relatively modest big-city neighborhood origins to its current national profile and reach, including a number of nationwide financial firms engaged exclusively or predominantly in payday lending, the industry has benefited from rapid growth and an embedded high-profit business model in becoming a $40 billion per year industry ─ good times, indeed. On the other side of the ledger, however, the payday lending industry has been the subject of what can only described as a regulatory gang-tackling at the federal level, an increased incidence of tough state payday loan laws, and a continuing hostile public relations offensive by leading consumer groups ─ certainly some bad times. And, behind the debate over payday lending there are some entrenched regulatory and public interest attitudes that are likely to prolong the intensity of the public discussion and throw a shadow over the continued expansion of this industry, which is a promise of interesting times for the foreseeable future.

***What is Payday Lending**?* Payday lending, also known as payday advance, is the popular name for what is more formally referred to as "deferred check presentment lending." In its basic ─ and predominant ─ form, a payday loan is a short-term, unsecured loan in a relatively small amount (generally under $500) that is made on the strength of a borrower's postdated check and a regular job. For the use of this money for a short time period, the borrower will pay the payday lender a fee (frequently in the range of $15 per $100 borrowed). A payday loan usually is made for no more than two or three weeks, and is supposed to enable customers to meet short-term cash flow demands until their next cash infusion ─ usually their next payday (hence the name). If the customer cannot repay the loan when it is due, the lender may cash the customer's postdated check or renew (or "roll over") the loan for another term.

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Payday loans offer the appeal to consumers of being fast, not paper-intensive (often, not much more than a current bank statement, pay stub and proof of residence/social security number will suffice) and convenient. They also are a source of credit — and cash — for consumers that have no or limited access to credit in the mainstream banking system because of their socioeconomic status or poor credit history. For this reason, payday lending is considered a form of "subprime" lending.

And, there lies the rub: consumer groups charge that payday lending is an inherently predatory activity that targets poor and blue-collar consumers who are coaxed into abusive lending relationships characterized by poorly-disclosed and exorbitant loan fees, oppressive collection practices, and a vicious circle of loan rollovers (each time with new fees) from which they cannot emerge. Payday lenders reply that their services benefit consumers by making credit available to segments of the population that do not have easy access to credit cards, banks loans and other more traditional financing alternatives, that their fees in many cases are lower than the bounced-check and other bank fees assessed on consumers with cash flow problems, and that the abusive practices in question are not used by responsible lenders. They also point to the fact that payday lending is becoming increasingly regulated at the state level and is subject to a full panoply of federal consumer protection laws. In addition, payday lenders have their political defenders, in that a number of members of Congress have encouraged the federal financial regulatory agencies not to regulate the payday lending industry out of existence.

The Regulatory Landscape. Payday lenders are regulated primarily at the state level, under state laws governing consumer finance activities in general, or in approximately thirty states, laws specifically governing payday lending activities. These various laws impose licensing, financial responsibility and various consumer protection requirements on payday lenders, including disclosures of payday lending fees as an annual percentage rate, and in many cases impose relatively strict interest rate (usury) caps on these lenders. Many payday lending statutes also specifically restrict or prohibit various types of practices that have been identified as "predatory," including the number and mechanics of payday loan rollovers, abusive collection practices and the like.

At the federal level, payday lenders are not subject to any specific body of financial regulation. Because they are non-bank lending organizations, they are not directly subject to federal banking laws, or the direct oversight of the various federal banking agencies. As consumer lenders, however, they are subject to a variety of consumer protection laws primarily administered by the Federal Trade Commission ("FTC"), including the Truth In Lending Act, the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, and the consumer protection provisions of the FTC Act. In addition, payday lending organizations are regulated as "financial institutions" by the FTC under the 1999 Gramm-Leach-Bliley Act's financial privacy requirements (Title V).

Living in the Current Regulatory Environment. The predominance of state regulation in the area of payday lending has discrete consequences for the way many payday lenders conduct their businesses. In order to avoid the application of multiple — and occasionally inconsistent — state regulatory requirements, and benefit from the more liberal usury limitations found in some states (and "export" those interest rates to other states), payday lenders have actively sought out formal business referral/marketing relationships with commercial banks and savings banks. These relationships have been structured for the most part as relationships whereby a bank agrees to fund and carry payday loans, and the payday lender agrees to market and service those loans. In this fashion, payday lenders can avoid inconsistent state usury and other consumer protection limitations. In addition, these alliances relieve payday lenders of the financial obligation to fund the loans made through these arrangements; in this manner, the payday lender can reduce its funding demands and costs, and the payday lenders and their partner banks benefit from the generally lower funding cost that banks enjoy under federal deposit insurance and the federal safety net.

The Regulatory Response. The reactions of the federal banking regulators to the payday lending activities of their regulated banks, in particular their partnerships with payday lending firms, has been harsh. The Office of the Controller of the Currency ("OCC") has been particularly hostile to efforts by payday lenders to "partner" with national banks. The OCC has taken several enforcement actions against national banks that have entered into marketing partnerships with payday lenders, and also has taken administrative action against at least two payday lenders, for alleged violations of law and unsafe and unsound banking practices. These problems, according to the OCC, arise from structural weaknesses in the relationships between national banks and payday lenders, in that the banks have been charged with significant lapses in their policies and procedures and risk management system in extending payday loans and managing the lending product. By effectively ceding responsibility for the actual payday lending activities to the payday lenders, according to the OCC, the national bank has effectively "rented its charter" to the payday lender. Comptroller of the Currency John T. Hawke has been unusually blunt in saying that he wants payday lenders to "stay the hell away" from national banks and the national banking system. And, it certainly appears that payday lenders and national banks have complied or are in the process of complying with this pointed request.

The other federal banking agencies have not been much kinder to payday lending organizations. The Office of Thrift Supervision issued guidance in late 2000 concerning savings institutions' relationships with payday lenders, and more recently has discouraged its constituent savings institutions from partnering with payday lenders. The Federal Reserve Board amended its TILA (Regulation Z) commentary in 2000 specifically to cover payday lending activities, and senior Federal Reserve Board officials recently have informally acknowledged the risks associated with payday lending activities, but the Federal Reserve Board has not made any formal statements about payday lending. At the same time, the fact that there appears at present to be only one Federal Reserve Board-regulated bank in the payday lending business might suggest that FRB's regulatory attitude has not been hospitable.

At this time, the Federal Deposit Insurance Corporation ("FDIC") may be the only federal banking agency that is institutionally prepared to tolerate marketing alliances between payday lenders and their regulated banking constituents (in this case, insured state nonmember banks). The FDIC this past summer published supervisory guidelines for payday lending activities which, in the main, make it difficult but not impossible for FDIC-regulated banks to establish marketing relationships with payday lending organizations. *See,* FDIC, *"Guidelines for Payday Lending,"* http://www.fdic.gov/regulations/safety/payday/index.html (2003). Among other things, the FDIC guidelines impose significant additional regulatory capital requirements on FDIC-regulated banks engaged in payday lending activities, and in effect require those organizations to treat all payday loans as classified assets (substandard) for regulatory reporting, risk management and loan loss reserving purposes. While the effect of the FDIC guidelines has not been, to date, to drive all FDIC-regulated banks out of the payday lending business, it nonetheless has significantly raised the bar on FDIC-regulated banks that want to engage, or continue to engage in, payday lending activities, whether on their own initiative or in partnership with a payday lending firm. Even this regulatory effort, however, has been criticized as inadequate by consumer lending groups.

At the state level, regulatory reactions to payday lending activities likewise have been stringent. Payday lenders and their bank partners have found themselves subject to various lawsuits by state

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regulators, municipalities and consumer groups alleging violations of state consumer protection and usury limitations in connection with payday lending activities conducted within those states. Other state regulatory authorities have indicated their interest in investigating payday lending activities, and at this date several of those investigations are ongoing.

The Payday Lending Conundrum. The intensity of the federal and state regulatory interest in payday lending is, in one respect, not altogether surprising, in that payday lending is, almost by definition, "subprime" lending. At the same time, payday lending nonetheless is a line of business that is subject to relatively substantial state and federal regulation, including the various consumer protection laws administered by the FTC. In addition, the simple growth of the payday lending industry demonstrates an obvious fact: there is a strong consumer demand for this product. While the principal customer base of the payday lending industry is lower-income and lower-middle-income consumers, as a general matter these consumers must have at least a steady job, a bank account and a social security number in order to qualify for a payday loan. And, while there certainly are predatory practices that can be associated with payday lending, including uncontrolled payday loan rollovers (with additional fees) and abusive collection practices, it would be an overstatement to say that these practices characterize the entire payday lending industry. There is also the fact that consumers who use the services of payday lenders often have limited, if any, access to mainstream financial services, and hence it is more than passing naïve for consumer organizations to suggest that these consumers ought to look to credit cards and other traditional bank products (which, if they are available at all, may end up being more costly than the payday lending alternative).

That being said, consumers who do not have ready access to mainstream financial services are in a relatively vulnerable posture vis-à-vis payday and other subprime lenders. Hence, there needs to be a recognition among payday lenders in general and their defenders that these lenders will have to accept the inevitability of significant — and relatively unfriendly — federal and state regulatory scrutiny. For those responsible players in the industry, the best course of action therefore lies in assuring that their payday lending operations are conducted in a transparent and straightforward manner with consumers, and in compliance with applicable laws and regulations. In turn, this would mean that payday lenders should accept an enhanced obligation to assure that their compliance policies and procedures, both in their creation and in their implementation, are robust, and that the payday lending organizations place regulatory compliance and fair treatment of consumers at the top of their priority lists. (Consumer groups, predictably, have scoffed at the self-reforming efforts of the payday lending industry, given their apparent desire that the industry not exist at all.)

Conclusion. In summary, the payday lending industry has to police itself; to do so, the industry has to assure, individually and collectively, that its members comply with applicable laws and regulations, and deal fairly and openly with their potential borrowers. On the issue of interest rate exportation and usury limitations, the issue may be more difficult for payday lenders, inasmuch as there appears to be a distinct trend to limit the amount of lending fees that payday lenders can charge in individual states; if that trend continues, of course, payday lenders will have to consider for themselves the continued economic viability of the payday lending business model. But, for the time being, the principal challenge facing payday lenders, as they attempt to emerge from the regulatory vortex in which they now find themselves, is to abide by simple good practices and good behavior.

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