



Deposit Advance Products – Final OCC and FDIC Guidance

Executive Summary

The Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) (collectively, the “Agencies”), each released final guidance in November 2013 entitled “Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products.” The final guidance is intended to ensure that banks are aware of a variety of safety and soundness, compliance, and consumer protection risks posed by deposit advance loans, as well as to supplement existing agency guidance on payday loans, subprime lending, and small dollar loans. The final guidance limits eligible consumers to one deposit advance loan per monthly statement and imposes a one-month cooling off period before a consumer can obtain a new deposit advance loan after repaying an earlier loan.

The final guidance is substantively the same as the proposal issued by both agencies on April 24, 2013 (please refer to Regulatory Practice Letter 13-11). However, the final form contains certain provisions that were amended to address concerns raised during the public comment period, including clarifying that eligibility and underwriting expectations will not require the use of credit reports and specifying that the guidance will apply to all deposit advance products, including products that are structured to resemble lines of credit.

Background

In April 2013, industry participants expressed concern that the heightened supervision over deposit advance products outlined in the proposed guidance, including underwriting restrictions and cooling off periods, would serve to limit the availability of deposit advance products if adopted. Since the release of the final guidance, these predictions have come to fruition as evidenced by the multiple numbers of banks that have publicly announced they plan to discontinue their offerings of deposit advance products.

A deposit advance product is a small-dollar, short-term credit product that banks make available to customers who have deposit accounts with recurring direct deposits. The agencies note that these loans typically have high fees, are repaid from the proceeds of the customer’s next direct deposit, and are repaid in a lump sum in advance of the customer’s other bills. The OCC and FDIC each state deposit advances “often are not subject to fundamental and prudent banking practices through which a bank can determine the customer’s ability to repay the loan and meet other necessary financial

obligations.” FDIC Chairman Gruenberg said, “The final supervisory guidance...aims to alert financial institutions to the risks posed by certain deposit advance products affordable products that are prudently underwritten and designed.”

Although the specific characteristics of deposit advance products may vary from bank to bank and over time, the products currently offered tend to incorporate some or all of the following characteristics:

- *Cost:* The deposit advance is typically based on a fee structure, as opposed to an interest rate, and can be more expensive than other forms of credit.
- *Eligibility, Loan Limits, and Ability to Repay:* To be eligible for a deposit advance, a customer typically must receive recurring deposits on a deposit account that has been open for a certain period of time. The maximum dollar amount of the advance is usually limited to a percent or amount of the recurring monthly deposit. In contrast to the traditional underwriting standards for other products followed by banks, which include an assessment of the customer’s ability to repay the loan, the decision to advance credit to customers is based solely on the amount and frequency of their deposits.
- *Repayment:* Loan repayment is typically done through an electronic payment of the fee and the advance out of the customer’s next direct deposit.
- *Repeat Usage Controls:* Banks often have repeat usage limits that trigger a “cooling off” period during which the customer cannot obtain another deposit advance or the credit limit is reduced.
- *Marketing:* Banks typically market deposit advance products as intended to assist customers in a financial emergency or to meet a short-term need. The advances, however, are usually listed as a deposit account “feature,” as opposed to a credit product.
- *Access:* Customers are usually alerted that the products are available through a reference on their account statement or a webpage hot link. The agencies note that it is not clear that customers are made equally aware of less expensive alternatives.

In April 2013, the Federal Reserve Board (Federal Reserve) issued a Statement on Deposit Advance Products (Consumer Affairs Letter CA 13-7) that emphasizes to state member banks the potential risks associated with the development, marketing, servicing, and collections of deposit advance products, including compliance risk, legal risk, and the risk of consumer harm. The guidance encourages state member banks to “respond to their customers’ small-dollar credit needs with products that meet this demand in a responsible manner.”

Description

The final guidance from the OCC and FDIC addresses potential credit, reputation, operational, and compliance risks associated with deposit advance products. The agencies expect banks to apply the principles set forth to any deposit advance product they offer. In final form, the guidance substantially follows the proposal, but includes clarifying language specifying the guidance applies to all deposit advance products, regardless of whether the product is structured as open- or closed-end credit.

Supervisory Concerns of Deposit Advance Loans

The OCC and FDIC continue to encourage banks to respond to customers' small-dollar credit needs in a "responsible manner" and with "reasonable terms and conditions," but, as noted by each of them, "deposit advance products share a number of characteristics with traditional payday loans, including high fees, short repayment periods, and inadequate attention to the ability to repay." Comptroller Curry adds, "These products have the potential to trap customers in a cycle of high-cost debt that they are unable to repay." Specifically, the guidance identifies the following safety and soundness concerns related to deposit advance loans:

- *Credit Risk:* The agencies suggest that borrowers who obtain deposit advance loans may have cash flow difficulties or blemished or insufficient credit histories that limit other borrowing options. Failure to implement adequate underwriting standards increases credit and default risk. Numerous and repeated extensions of credit to the same individual may be substantially similar to continuous advances and subject the institution to increased credit risk.
- *Reputation Risk:* Heightened news coverage and public scrutiny of deposit advance products increases the reputational risk for institutions engaging in practices that are perceived to be unfair or detrimental to the consumer.
- *Compliance/Legal Risk:* The risks associated with deposit advance lending products may subject institutions to the risk of litigation – both from private lawsuits and regulatory enforcement actions.
- *Operational/Third-Party Risk:* Banks must keep in mind that they remain responsible and liable for compliance with all applicable laws and regulations, even for the activities of third parties who may work with banks to develop, design, and service deposit advance products.

Institutions that offer deposit advance products must comply with all applicable federal laws and regulations, as well as state laws as appropriate, including usury laws and laws governing unfair or deceptive acts or practices.

Supervisory Expectations

To address the consumer protection and safety and soundness concerns associated with deposit advance lending, the agencies state they will take appropriate supervisory action to prevent harm to consumers, to address any unsafe or unsound banking practices associated with these products, and to ensure compliance with all applicable laws. Examinations will focus on potential safety and soundness issues, as follows, as well as compliance with applicable consumer protection statutes.

- *Credit Quality:* The agencies state that deposit advance loans that have been accessed repeatedly or for extended periods of time could be evidence of an inability to repay and inadequate underwriting, and will be criticized by examiners.
- *Underwriting and Credit Administration Policies and Practices:* Examiners will also consider underwriting and administrative policies and practices for deposit advance loan products, including documented policies of the eligibility and underwriting criteria intended to prevent churning and prolonged use of the products. Policies should be written and approved by the bank's board of directors and be consistent with the bank's general underwriting standards and risk appetite. Factors that a bank will need to address in their written underwriting policies include:
 - A customer's deposit advance eligibility should be based on a relationship of no less than six-months

- Customers with delinquent or adversely classified credit should be ineligible
- An analysis of a customer's financial capacity, including income levels, should be conducted though review of the customer's credit report is not required
- Each deposit advance loan should be repaid in full before the extension of a subsequent loan
- No more than one loan should be offered in one monthly statement cycle
- A cooling off period of at least one monthly statement cycle after the repayment of a deposit advance loan should be completed before another advance may be extended
- Credit available for deposit advances should not be increased without a full underwriting reassessment
- Customer eligibility should be reassessed every six months.
- *Capital Adequacy*: Higher capital requirements generally apply to loan portfolios that exhibit higher risk characteristics such that loans exhibiting subprime credit characteristics will be considered higher risk and may require additional capital.
- *Over-Reliance on Fee Income*: Institutions should monitor for any undue reliance on fees generated by deposit advance products in revenues and earnings/
- *Adequacy of the Allowance for Loan and Lease Losses (ALLL)*: Examiners will assess whether the ALLL is adequate to absorb estimated credit losses within the deposit advance loan portfolio, and determine whether banks engaged in deposit advance lending have appropriate methodologies and analyses in place.
- *Consumer Compliance*: Banks are expected to implement effective compliance management systems, processes, and procedures to appropriately mitigate risks and ensure compliance with applicable consumer protection regulations.
- *Management Oversight*: Examiners will assess bank management's ability to administer a deposit advance loan program, including board oversight roles and established controls to identify, measure, monitor, and manage the related risks.
- *Operational Risk and Third-Party Relationships*: Examiners will review the risks associated with all material third-party relationships and activities.

Commentary

As predicted, banks have begun to exit the deposit advance products market as supervisory expectations for those products have heightened. Concerns remain, however, that consumers will seek replacement alternatives to the deposit advance products that, for the consumer, may in fact be more risky sources of credit. The OCC and FDIC both encourage banks to develop and offer products that meet the small-dollar credit needs of their customers but caution against products that share characteristics with traditional payday loans, (such as high fees, short repayment periods, and "inadequate attention to ability to repay.") The regulators will likely subject any new products developed to serve this market to close examination.

The Bureau of Consumer Financial Protection (CFPB) supervises both bank and nonbank providers of consumer credit and has stated that it expects to use its authorities to provide consumer protections to small-dollar lending. Payday loans and

deposit advance products are listed among its most recent rulemaking agenda items. It is also actively looking at low-dollar credit and prepaid cards. Banks and nonbanks should anticipate regulatory scrutiny over these products and any related new product offerings (over the entire product lifecycle) as well as the release of regulatory guidance, rule-makings and enforcement actions (noting the first enforcement action against a payday lender was taken by the CFPB in November 2013).

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