

Regulatory Practice Letter

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Payday Lending– CFPB Data Point Report

Executive Summary

The Consumer Financial Protection Bureau (CFPB or Bureau) recently released a report presenting the results of several analyses of consumers' use of payday loans. The report is considered to be a continuation of the CFPB's report, *Payday Loans and Deposit Advance Products*, which was released in April 2013. It was prepared by the CFPB's Office of Research and is intended to look more closely at consumers' patterns of repeated borrowing. The CFPB states a primary driver of the cost of payday loans is the ability for consumers to roll over the loans or engage in reborrowing within a short window of time after repaying their first loan.

The analyses focused on "loan sequences" or the series of loans borrowers take out following a new payday loan. The CFPB considers any loans taken out within 14 days of paying off a previous loan to be part of the same loan sequence. The report showed the renewal rates for payday loans is greater than 80 percent.

Coincident with the release of the report, CFPB Director Richard Cordray said the Bureau's concern is not with every payday loan made to a consumer, but with the inability of some consumers to escape the cycle of debt. The Bureau is now "in the late stages" of determining an approach to formulating rules for this market that would protect consumers from what he referred to as "debt traps" while also assuring they will have access to a small loan market that is "fair, transparent, and competitive."

Separately, the Financial Institutions and Consumer Protection Subcommittee of the U.S. Senate Committee on Banking, Housing, and Urban Affairs conducted a hearing in March to solicit testimony on whether alternative financial credit products serve consumers. Witnesses included both critics of the payday lending industry as well as critics of efforts to eliminate or control the industry. Most favored a federal law governing the industry instead of myriad state laws.

Background

The CFPB gained supervisory authority over non-depository (nonbank) payday lenders, regardless of size, pursuant to Section 1024 of the *Dodd-Frank Wall Street Reform and Consumer Protection Act.* Prior to the launch of the CFPB's nonbank supervisory program, payday lenders were not generally subject to federal regulatory oversight (they were, however, covered by the unfair and deceptive acts or practices rules of the *Federal Trade Commission Act*). Some states have enacted specific legislation to

modify their usury laws to permit the payday lending activity. In states where payday lending is permitted, payday lenders are required to comply with laws applicable to the state in which they are located. The CFPB indicates these states often have rules to limit sustained use, such as limiting the number of loans made in a given year or mandating a "cooling off" period.

The CFPB has been actively exercising its authorities over the payday lending market since beginning its nonbank supervision program in January 2012. At that time, the Bureau released examination procedures specifically covering "Short-Term, Small Dollar Lending," which described the types of information examiners will gather to evaluate payday lenders' policies and procedures, assess whether lenders are in compliance with federal consumer financial laws, and identify risks to consumers throughout the lending process - "from initial advertisements and marketing to collection practices." The CFPB stated it would implement the "payday lending supervision program based on its assessment of risks to consumers, including consideration of factors such as the volume of business and the extent of state oversight," and in coordination with its "federal and state partners" to maximize supervisory capability and minimize regulatory burden. The CFPB released updated examination guidance in September 2013 to instruct examiners on how to identify consumer harm and risks related to violations of the Military Lending Act (MLA) when supervising payday lenders. Servicemembers are afforded consumer protections under the MLA, including annual percentage interest rate caps of 36 percent and restrictions on loan rollovers.

In November 2013, the Bureau began accepting consumer complaints related to payday loans and also undertook its first enforcement action against a payday lender.

Regulatory Practice Letter 13-11 provided an overview of the CFPB's April 2013 report, *Payday Loans and Deposit Advance Products*. The findings in this report generally indicated that:

- Payday loans and deposit advances are similar products structured to meet shortterm credit needs (i.e., one pay cycle or other recurring payment cycle).
- Some consumers use payday loans and deposit advances at "relatively low to moderate levels," though a "sizable share" of users conduct transactions on a long-term basis (marked by a "pattern of repeatedly rolling-over or consistently reborrowing"), which the CFPB terms "sustained use."
- Long-term use of these products suggests some consumers are unable to repay their loan in full and still meet their other expenses requiring continuous reborrowing and significant expense to repeatedly carry this debt.
- The high cost of payday loans and deposit advance products may contribute to the chronic difficulty some consumers face in retiring the debt.
- To the extent these products are marketed as a short-term obligation, some consumers may misunderstand the costs and risks of repeated borrowing.
- "Further attention is warranted to protect consumers" from harm.

Regulatory Practice Letter 14-02 outlined the final guidance released by the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation regarding deposit advance products (defined by the CFPB as a "variant" of payday loan products), and the related withdrawal of financial institutions from that market. The CFPB has included payday loans and deposit advance products among its rulemaking agenda items for 2014.

Description

CFPB Data Point Report: Payday Lending

Key Findings

Based on its April 2013 findings, the Office of Research initiated a detailed analysis of borrowing patterns using information obtained from storefront lenders on more than 12 million loans located in 30 states and covering 12-month periods in 2011 and 2012. The key findings from this more focused report indicate:

- Over 80 percent of payday loans are rolled over (renewed) or followed by another loan within 14 days. Same day renewals are less frequent in states with mandated cooling-off periods, but 14-day renewal rates in states with cooling-off periods are nearly identical to states without these limitations.
- Approximately 15 percent of new loans are followed by a loan sequence at least 10 loans long. Half of all loans are in a sequence of at least 10 loans long.
- Few borrowers amortize, or have reductions in principal amounts, between the first and last loan of a loan sequence. For more than 80 percent of the loan sequences that last for more than one loan, the last loan is the same size as or larger than the first loan in the sequence. Loan size is more likely to go up in longer loan sequences, and principal increases are associated with higher default rates.
- Monthly borrowers are disproportionately likely to stay in debt for 11 months or longer. Among new borrowers (i.e., those who did not have a payday loan at the beginning of the year covered by the data), 22 percent paid monthly and averaged at least one loan per pay period. The majority of monthly borrowers are government benefits recipients.
- Most borrowing involves multiple renewals following an initial loan, rather than multiple distinct borrowing episodes separated by more than 14 days. Roughly half of new borrowers (48 percent) have one loan sequence during the year. Of borrowers who neither renewed nor defaulted during the year, 60 percent took out only one loan.

Director Cordray's Remarks

Calling the study "the most in-depth analysis to date of this pattern," CFPB Director Richard Cordray said the Bureau's concern is not with every payday loan made to a consumer, but with the inability of some consumers to escape the cycle of debt. "Preserving access to small dollar loans does mean, after all, that some such loans should be available," said Cordray at the Payday Field Hearing in March in Nashville. He said the "perpetuating sequence" of loans hurt rather than helped consumers using "this extremely high-cost loan product."

Director Cordray indicated that since the Bureau began taking payday loan complaints in November 2013, it has received several thousand complaints from people that have "gotten caught in these spider webs of debt." The Bureau is now close to formulating rules for this market that he said would protect consumers from what he called "debt traps" while also assuring they will have access to a small loan market that is "fair, transparent, and competitive."

Consumer Complaints. The Bureau's 2013 Annual Report on Consumer Response noted that approximately 1,000 complaints related to payday loans and deposit advance products were submitted to the CFPB in November and December. Of

those, the most common complaint (37 percent) cited unexpected charges for fees or interest. That was followed by complaints related to failure to receive funds after applying for a loan (22 percent), an inability to contact the lender (15 percent), and other complaints related to payments, such as the use of check holds and electronic debit authorizations (16 percent in combination). Consumers also raised concerns about the risk of being unable to repay the loan while still having enough money left over for other expenses, the high cost of the loan, and aggressive debt collection practices in the case of delinquency or default.

Notably, the CFPB allows state agencies "real time access" to its consumer complaints database and has reached agreements with some states to share complaint information.

Other Developments

U.S. Senate Subcommittee Hearing: "Are Alternative Financial Products Serving Consumers?"

The Financial Institutions and Consumer Protection Subcommittee of the U.S. Senate Committee on Banking, Housing, and Urban Affairs conducted a hearing on payday lending on March 26, 2014. Five witnesses, including representatives of academia, industry research groups, consumer associations, and payday lenders, provided testimony in answer to the question, "Are Alternative Financial Products Serving Consumers?" Some testified they had conducted research studies similar to the CFPB's two studies and had reached similar findings.

The witnesses generally appeared to favor federal guidance to regulate the payday lending and small dollar credit market. Highlights of their testimony include the following observations and statements:

- Demand for short-term, low-dollar products is growing.
- A trend is developing away from a two-week loan product toward an instalment product with a longer term. This trend is driven in part by an increase in the average loan amount and the intensity of usage.
- There is value in the two-week loan product because it is usually less costly than overdrafts which are less costly than returned NSF items.
- Federal law is needed to establish rules and regulations to govern consumer short-term, low dollar credit nationwide, including internet based lending, and to increase certainty for product innovators and providers. Real innovation is limited because of the patchwork of legacy state laws governing these products.
- Rules and regulations should require assessment of a borrower's ability to repay a loan, in full and on time, as well as address annual percentage rates and methods of payback.
- Payday loans are neither safe nor affordable, and access to them is more of a burden than a benefit. If these loans cannot be made more affordable, the loans should not be made. As long as these forms of credit exist, alternatives for low and middle income people with poor credit will not be become available.

One witness proposed "five regulations for reforming payday loans" that the witness said would "minimize harm to consumers and make all small-dollar loans more affordable." The witness, who offered the suggestions "to support the CFPB and other policymakers," proposed the reforms should apply to all small dollar payday and

instalment loans to "ensure an effective and simplified regulatory environment." In particular, the witness suggested:

- Limiting payments to "an affordable percentage" of a borrower's income. Loans requiring more should be prohibited unless rigorous underwriting shows that the borrower can repay the loan while meeting other financial obligations. (The witness suggested that monthly payments above 5 percent of monthly pretax income are unaffordable for most borrowers.)
- 2 Spreading costs evenly over the life of the loan and prohibiting the front-loading of fees and interest. Loans should have substantially equal payments that amortize smoothly to a zero balance.
- 3 Guarding against repayment or collections practices that are harmful to consumers. The use of postdated checks and automatic withdrawals from borrowers' bank accounts should be limited or prohibited and it should be made easier to cancel automatic electronic withdrawals.
- 4 Requiring concise disclosures of periodic and total costs. Loan offers should clearly disclose, with equal weighting: the periodic payment schedule, the total repayment amount, the total finance charge, and the effective annual percentage rate inclusive of all fees.
- 5 Continuing to set maximum allowable charges. (The witness stated that almost every state sets maximum allowable rates on some small-dollar loans and further suggested that rate limits of 36 percent or less may inhibit the operation of payday lenders.)

Industry News

The CFPB has stated that it is studying online payday lending activities separately from storefront businesses though it has not yet released a report analyzing the online market. However, it is notable that the CFPB initiated its first enforcement action against an online lender and servicer in December 2013 alleging that the company engaged in unfair, deceptive, or abusive acts or practices (UDAAP) including illegally debiting funds from consumers' checking accounts for loans that were void. The CFPB's investigation showed that the high-cost loans violated either licensing requirements or interest-rate caps – or both – in at least eight states. Any obligation to pay such loans was rendered void or otherwise nullified in whole or in part by the state statutes.

The CFPB has jurisdiction over a broad array of companies, including online lenders, loan servicers, and debt collectors. The Bureau states that it considers this lawsuit "a significant step" in its efforts to address "regulatory-evasion schemes" that it says are increasingly becoming a feature of the online small-dollar and payday lending industry. The Bureau states that it worked "closely and collaboratively" with state attorneys general and banking regulators in bringing the lawsuit, noting that the states are pursuing related litigation.

During 2013, the Department of Justice (DOJ) initiated "Operation Choke Point," which is intended to investigate banks' relationships with online payday lenders and other companies that have raised regulatory concerns. The DOJ entered into its first enforcement action under this initiative in January 2014 against a bank that had processed ACH transactions for payday lenders through an arrangement with a third-party payment processor. Based on allegations of inadequate diligence and

control over the payment processor and its customers, the DOJ obtained \$1.2 million in monetary relief and injunctive relief to address the bank's dealings with third-party payment processors and with Internet short-term (payday) lenders, among others.

News reports indicate that some banks have begun to terminate relationships with payday lenders and payment processors as those companies come under increasing scrutiny. In response, Mark Pearce, director of the FDIC's Division of Depositor and Consumer Protection stated in an April 11, 2014, interview with the *Washington Post*, "If you have relationships with a [payday lending] business operating in compliance with the law and you're managing those relationships and risks properly, we neither prohibit nor discourage banks providing services to that customer."

State Actions. Section 1042 of the Dodd-Frank Act gives state attorneys general the authority to bring civil actions on behalf of their states, against a defendant over which the state has jurisdiction, to enforce the provisions of Title X, which established the CFPB. Section 1042 also gives authority to a state regulator to bring civil action against entities authorized to do business under the state law in order to enforce the provisions of Title X. Federal consumer financial laws and regulations covered by Title X and applicable to payday loans include the *Truth-in-Lending Act, Electronic Funds Transfer Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, Fair Credit Reporting Act*, portions of the *Gramm-Leach-Bliley Act* that pertain to consumer privacy, and the UDAAP provisions.

In March 2014, the Illinois State Attorney General became the first to use the Section 1042 authority to file an action against a short-term lender that included violations of UDAAP and other (Illinois) state laws. The Illinois State Attorney General has subsequently filed lawsuits (apart from its Section 1042 authority) against four online payday lenders alleging they engaged in illegal, predatory lending activities in the state where they were not licensed to operate. In April 2014, the Superintendent of the New York Department of Financial Services became the first state regulator to use the Section 1042 authority, filing a suit against an auto lender for violations of UDAAP.

These actions are widely expected to be the beginning of many state-initiated actions to enforce consumer protection and fair lending laws under the Dodd-Frank Act, which will support and further focus the efforts of the CFPB in this market.

Commentary

Banks and nonbanks should anticipate heightened regulatory scrutiny over payday loans and related product offerings at both the federal and state levels in the near term. Regulatory agencies will be considering a broad array of institutions' direct and indirect relationships, including lending activities conducted in-house or through affiliates (to consumers or to finance other finance companies), activities of third-party service providers (such as payment processors) that could expose an institution to risk (compliance, legal, reputational), and deposit accounts held by customers that operate or provide services to payday lending businesses. They will be looking, as

appropriate, to assess whether lenders are in compliance with federal and state consumer financial laws, and to identify risks to consumers throughout the lending process – "from initial advertisements and marketing to collection practices."

Given the regulators recent guidance on heightened expectations for operating standards and third-party oversight, institutions should expect to fully assess the potential risks associated with all relationships that touch payday lending and similar short-term, small dollar credit products to ensure that they have identified the inherent risks and that those risks align with the firm's business strategies, are consistent with the stated risk appetite, and are covered by policies, procedures, and controls that can identify, measure, and mitigate such risks.

Critically, firms must recognize that states are as likely to initiate enforcement actions as the CFPB and, with regard to online lending, possibly more likely to act first to enforce the laws specific to their jurisdiction. Similarly, institutions are vulnerable to action by state authorities with regard to enforcement of the federal consumer financial laws under the Dodd-Frank Act in their state. The CFPB has initiated two public enforcement actions against payday lenders since late 2013 and multiple states have similarly acted to control the actions of payday lenders in their states. This activity is not expected to abate, and may actually gain momentum with commensurate increases in penalties and other payments.

Director Cordray stated that the CFPB is close to formulating an approach to new rules that will "bring needed reforms to this market." He also said, "...the American consumer has shown a clear and steady demand for small-dollar credit products, which can be helpful for the consumers who use them on an occasional basis and can manage to repay them without becoming mired in a prolonged and costly struggle. So we intend to make sure that consumers who can afford to take out small-dollar loans can get the credit they need without jeopardizing or undermining their financial futures." Based on areas of concern previously noted by the CFPB, such rules could consider: underwriting criteria, product terms (such as APRs), marketing and disclosure materials, constructs to inhibit sustained use (such as restricting fees and lengthening repayment terms) and, potentially, product availability. Interestingly, the CFPB's Data Point report highlights the finding that a "cooling off" period (of up to 14 days) does not necessarily limit the length and number of payday loans borrowed by consumers.

Federal consumer financial laws applicable to this market include the *Truth-in-Lending Act, Equal Credit Opportunity Act, Fair Debt Collection Practices Act, Fair Credit Reporting Act, Electronic Funds Transfer Act,* and privacy provisions of the *Gramm-Leach-Bliley Act,* as well as the provisions of UDAAP, the MLA, and CFPB guidance related to third-party service providers.

It has generally been the CFPB's practice to gather information through consumer complaints and information requests and, based on the problem areas identified by consumers, to follow with enforcement actions and/or supervisory guidance. One of the CFPB's recent actions was against an online payday lender, increasing the likelihood that any upcoming rulemaking will reach online activities. The rulemaking is also expected to go beyond traditional payday loans to broadly include similar products

or "payday lending variants," such as deposit advance products, title loans, refund advances, small dollar credit or prepaid cards, short-term, small dollar loans, or other replacement products to be developed by bank and nonbank lenders that are adapted to short-term, small dollar credit criteria.

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