What You Need to Know About the CFPB's Short-Term, Small-Dollar Lending Examination Procedures

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September 27, 2012

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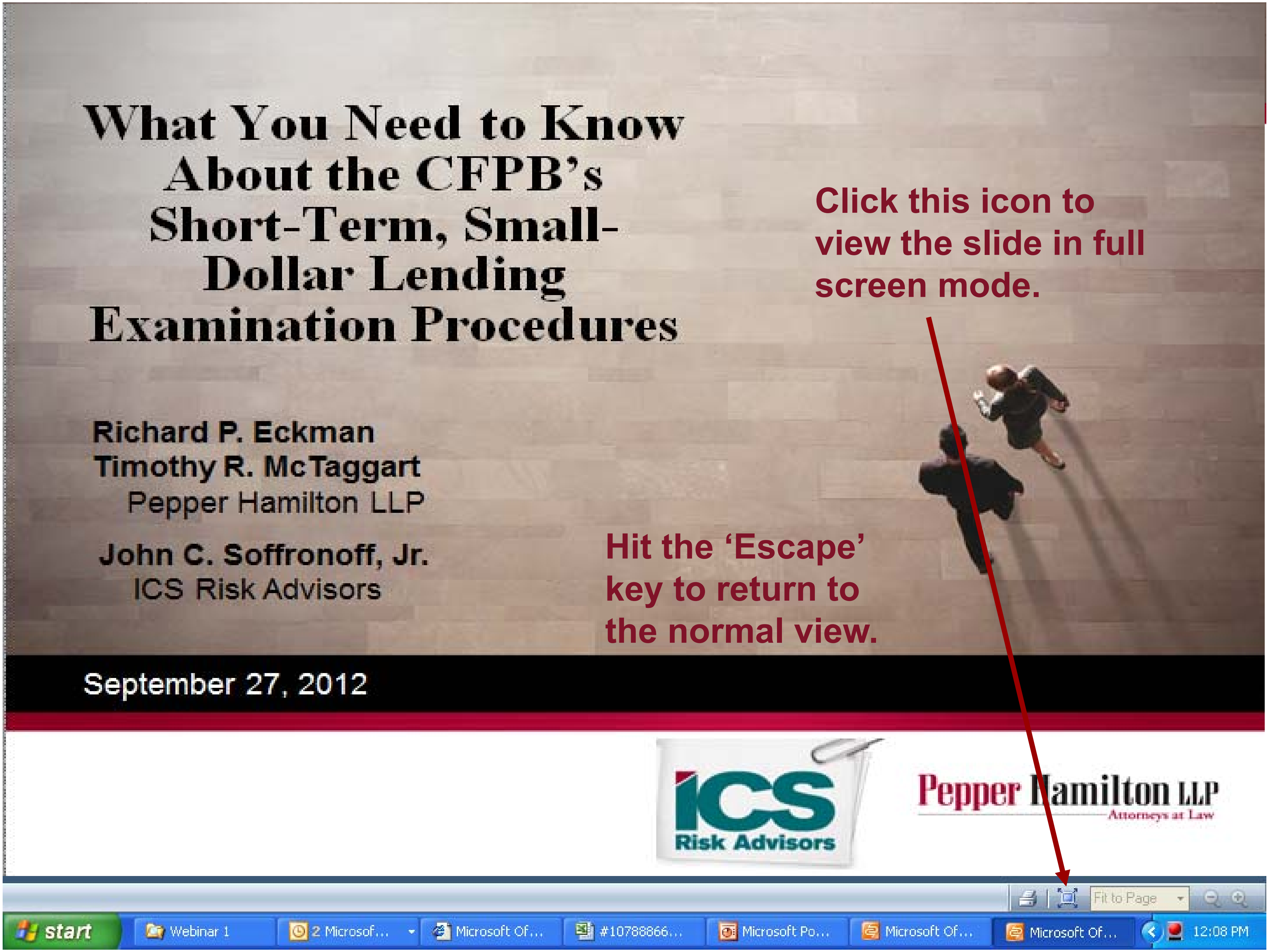
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Dodd-Frank Act and Financial Services Reform Resource Center

Tuesday, September 04, 2012

The recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) will affect almost every facet of the U.S. financial services industry. This legislative behemoth, intended to restore public confidence in the financial services industry, prevent future financial meltdowns, and manage systemic risk, will restructure existing regulatory agencies, enhance the powers of federal regulators, and create advisory bodies that will touch upon a broad spectrum of financial services activities, institutions, and professionals.

Despite the comprehensive nature of the Dodd-Frank Act, the legislation leaves an extraordinary number of matters to be addressed through rulemaking and other regulatory action, establishes broad discretion for federal regulators, and may require additional legislative corrections during the next session of Congress.

To prepare for and survive the new legislative and regulatory requirements that will undoubtedly come in the wake of the Dodd-Frank Act, financial institutions and financial professionals must understand who the legislation covers, what activities it will affect, and how

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August 28, 2012

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Attorneys at Law

Moderator: Timothy R. McTaggart

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- Partner in the Washington office of Pepper Hamilton LLP and previously served as the Delaware State Bank Commissioner
- Focuses his practice on bank and financial services regulatory matters
- Assists financial services clients on transactional and enforcement issues
- Has represented clients before the federal bank regulatory agencies, including the Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Department of Treasury and the Board of Governors of the Federal Reserve System, as well as various state banking departments across the country.

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- President of ICS Risk Advisors
- Coordinates with senior executives and boards of directors to implement efficient and effective compliance programs.
- Former FDIC regulator for over 10 years and Review Examiner in the NY Regional Office for the Division of Compliance and Consumer Affairs
- Partners with financial institutions of all sizes, from some of the nation's largest financial institutions to community banks

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Table of Contents

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- The focus of this webinar is the CFPB’s Short-Term, Small-Dollar Examination Manual.

- Forthcoming Pepper webinars will focus on the two other specialty examination procedures updates the CFPB issued:
  - (1) Mortgage origination examination procedures released January 11, 2012; and
  - (2) SAFE Act examination procedures released March 7, 2012.

I. CFPB's Enforcement Authority

- CFPB Enforcement Authority
  - Authorized to conduct investigations to determine violations of Federal consumer financial law;
  - Investigations:
    - Conducted jointly with other regulators,
    - Include subpoenas or civil investigative demands.
  - Administrative enforcement proceedings;
  - Civil actions in Federal district court.

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I. CFPB's Enforcement Authority

- Legal or equitable relief for violations of Federal consumer financial law, including, but not limited to:
  - Rescission or reformation of contracts;
  - Refund of money or return of real property;
  - Restitution;
  - Disgorgement or compensation for unjust enrichment;
  - Payment of damages or other monetary relief;
  - Public notification regarding the violation;
  - Limits on activities or functions of person against whom action is brought; and
  - Civil monetary penalties (go to victims or financial education).

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II. Overview of Examination Procedures

- The CFPB issued its Short-Term, Small-Dollar Examination Procedures on January 19, 2012.
- Federal Consumer Financial Laws and Regulations Applicable to Payday Loans:
  - Truth in Lending Act;
  - Electronic Funds Transfer Act;
  - Fair Debt Collection Practices Act;
  - Fair Credit Reporting Act;
  - Gramm-Leach Bliley Act;
  - Equal Credit Opportunity Act; and
  - UDAAP: unfair, deceptive, or abusive acts or practices.

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II. Overview of Examination Procedures

- Overview of Examination Procedures
  - Apply to the short-term, small-dollar credit market, commonly known as "payday lending."

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II. Overview of Examination Procedures

- Overview of Payday Loans
  - Purpose: bridging a cash-flow shortage between pay or benefits checks.
  - Three General Features:
    - Small-dollar: generally no more than several hundred dollars;
    - Short-term: anywhere from less than one month to multiple months; and
    - Require borrower giving lender access to repayment through a claim on the borrower’s deposit account.

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II. Overview of Examination Procedures

- Other Payday Loan Features:
  - Repayment: balloon, installment, or interest-only;
  - Open-end or closed-end;
  - Disbursements: cash, prepaid card, ACH network, or check;
  - Loan fees can equate to APRs that exceed 300%;
  - Lenders do not underwrite applicants using traditional credit criteria, consumers typically need only a regular source of income to qualify;
  - Some payday loans are marketed as "advances."

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II. Overview of Examination Procedures

- Examination Objectives:
  - (1) Assess the quality of the regulated entity's compliance risk management systems, including its internal controls and policies, for its payday lending business.
  - (2) Identify acts or practices that materially increase the risk of violations of federal consumer financial laws in connection with payday lending.

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II. Overview of Examination Procedures

- Examination Objectives (cont.):
  - (3) Gather facts that help to determine whether a regulated entity engages in acts or practices that violate the requirements of federal consumer financial laws.
  - (4) Determine if a violation of a federal consumer financial law has occurred and whether supervisory or enforcement actions are appropriate.

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II. Overview of Examination Procedures

- Federal Consumer Financial Laws and Regulations Applicable to Payday Loans:
  - Truth in Lending Act;
  - Electronic Funds Transfer Act;
  - Fair Debt Collection Practices Act;
  - Fair Credit Reporting Act;
  - Gramm-Leach Bliley Act;
  - Equal Credit Opportunity Act; and
  - UDAAP: unfair, deceptive, or abusive acts or practices.

II. Overview of Examination Procedures

- Special CFPB Focus
  - UDAAP: unfair, deceptive, or abusive acts or practices.
    - A representation, omission, act or practice is deceptive when:
      - (1) the representation, omission, act, or practice misleads or is likely to mislead the consumer;
      - (2) the consumer's interpretation of the representation, omission, act, or practice is reasonable under the circumstances; and
      - (3) the misleading representation, omission, act, or practice is material.

II. Overview of Examination Procedures

- Standards for Assessing UDAAPs
  - An act or practice is unfair when:
    - (1) it causes or is likely to cause substantial injury to consumers;
    - (2) the injury is not reasonably avoidable by consumers; and
    - (3) the injury is not outweighed by countervailing benefits to consumers or to competition.

II. Overview of Examination Procedures

- Standards for Assessing UDAAPs (cont.)
  - An abusive act or practice:
    - (1) materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
    - (2) takes unreasonable advantage of –
      - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
      - the inability of the consumer to protect its interests in selecting or using a consumer financial product or service; or
      - the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

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II. Overview of Examination Procedures

- Standards for Assessing UDAAPs (cont.)
  - The particular facts and circumstances in a case are crucial to the determination of UDAAPs.
  - Examiners are directed to consult with CFPB headquarters to determine whether the applicable legal standards have been met before a UDAAP violation is cited.
  - In a letter dated July 2, 2012, David Hirschmann, President of the U.S. Chamber of Commerce’s Center for Capital Markets Competitiveness requested that the CFPB issue a policy statement defining “abusive.”

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III. Examination Modules

- Structure of Examination and Supervision Manual:
  - 17 pages long;
  - Divided into five examination modules:
    - (1) Marketing;
    - (2) Application and Origination;
    - (3) Payment Processing and Sustained Use;
    - (4) Collections, Accounts in Default, and Consumer Reporting; and
    - (5) Third-Party Relationships.
  - Each module identifies relevant examination matters for review in the various life cycles of a payday loan.

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III. Examination Modules

- Examination Modules: General Considerations
  - To complete the modules, examiners should obtain and review the following as applicable:
    - organizational charts and process flowcharts;
    - board minutes, annual reports, or the equivalent to the extent available;
    - relevant management reporting, including aggregate loan data to the extent available;
    - policies and procedures;
    - price structure;
    - loan applications, loan account documentation, telephone recordings, notes, and disclosures;

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III. Examination Modules

- Examination Modules: General Considerations (cont.)
  - To complete the modules, examiners should obtain and review the following as applicable:
    - operating checklists, worksheets, and review documents;
    - relevant computer program and system details;
    - historical examination information;
    - audit and compliance reports;
    - training programs and materials;
    - third-party contracts;
    - advertisements, marketing research, and website information; and
    - complaints.

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III. Examination Modules

- Examination Modules: General Considerations (cont.)
  - Depending on the scope of the examination, examiners should perform transaction testing using approved sampling procedures, which may require use of a judgmental or statistical sample.
  - Examiners should also conduct interviews with management and staff to determine whether they understand and consistently follow the policies, procedures, and regulatory requirements applicable to payday lending; manage change appropriately; and implement effective controls.
  - In consultation with CFPB headquarters, examiners may also consider using customer surveys.

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III. Examination Modules

- Examination Modules: General Considerations (cont.)
  - In consultation with CFPB headquarters, examiners may also consider using customer surveys.
  - Dangers of Using Consumer Surveys:
    - No opportunity for industry to “cross-examine” the “neutral” testing administrator;
    - Danger of small sample size – statistical insignificance;
    - Inaccurate cross-section of the consumers; and
    - Potential for testing bias.

III. Examination Modules

- Module 1: Marketing
  - Examiners should develop a detailed understanding of the lender's marketing program:
    - Identify a lender's marketing targets and its methods for reaching those targets.
    - Evaluate the lender's advertising materials and disclosures across all media.
    - Identify the practices and product features that are rewarded by any incentive compensation programs.
    - Determine whether a lender employs or acts as a third-party lead generator and the extent of any relationships that the lender has with affiliated or other third parties (e.g., as a broker or agent) to advertise, offer, or provide loans or other products and services.

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III. Examination Modules

- Module 1: Marketing
  - Advertising Requirements (cont.)
    - Truth in Lending Act / Regulation Z:
      - Determine whether the lender's advertisements are consistent with the requirements of Regulation Z.
      - Regulation Z: requires lenders to disclose loan terms, APRs, advertising disclosures, credit payments properly, and provide periodic disclosures.
    - Equal Credit Opportunity Act / Regulation B:
      - Assess how the lender reaches its potential customers through its statements, advertising, or other marketing representations.
      - Regulation B: sets forth requirements for accepting applications and providing notice of any adverse action, and prohibits discrimination.

III. Examination Modules

- Module 1: Marketing
  - Advertising Requirements (cont.)
    - Compensation Practices:
      - If the lender offers an incentive compensation program, identify the products, product features, services, referrals, and sales goals or behaviors that qualify for rewards under the program.
    - Lead Generation:
      - Identify whether the lender is, or uses, a lead generator and, as applicable, review the advertising materials.

III. Examination Modules

- Module 2: Application and Origination
  - When lenders take applications, evaluate applicants, and originate payday loans, they are subject to the following requirements:
    - Equal Credit Opportunity Act / Regulation B
      - Examiners should use the CFPB's ECOA examination procedures to assess the lender's compliance with requirements for taking applications, evaluating customer qualifications, providing disclosures (i.e., adverse action), and extending and denying credit.
    - Fair Credit Reporting Act
      - Lenders that obtain information from a consumer reporting agency to determine a consumer's credit worthiness must comply with the requirements of FCRA.

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III. Examination Modules

- Module 2: Application and Origination (cont.)
  - Truth in Lending Act / Regulation Z
    - Determine whether the appropriate disclosures required for the loan type (i.e., disclosures for closed-end credit vs. open-end credit) are being provided by the lender, and
    - Examine the loan product to verify that the product being offered conforms to the lender’s representations.
  - Electronic Fund Transfer Act / Regulation E
    - If the lender has established electronic fund transfers from the borrower’s account, examiners should use the CFPB’s EFTA examination procedures to review the extent to which the lender is complying with the EFTA.

III. Examination Modules

- Module 3: Payment Processing and "Sustained Use" (i.e., Rollovers)
  - Examiners should review a sample of customer accounts for the following issues:
    - Truth In Lending Act / Regulation Z
      - Assess compliance, as applicable, with the open- or closed-end TILA requirements for payment processing, billing errors and inquiries, credit balances larger than $1, and periodic statements.
    - Electronic Fund Transfer Act / Regulation E
      - Determine whether lender is complying with appropriate disclosure requirements if lender is:
        - Converting check payments from borrowers to electronic fund transfers, or
        - Collecting returned item fees by electronic fund transfer.

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- Module 3: Payment Processing and "Sustained Use" (i.e., Rollovers) (cont.)
  - Sustained Use
    - When a borrower cannot repay a loan by its due date, lenders may allow the borrower to modify or "roll over" the loan by paying an additional fee to extend the loan term.
    - A lender may also engage in a transaction in which a borrower uses the proceeds from a new loan to satisfy and pay off an older loan.
    - If these transaction types are prohibited by state law, a borrower may be asked to repay one loan before opening a new loan.

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III. Examination Modules

- Module 3: Payment Processing and “Sustained Use” (i.e., Rollovers) (cont.)
  - If the lender offers the Sustained Use options, the examiners must determine it the lender:
    - Accurately represents the payment options available to borrowers;
    - Discloses clearly and prominently all fees and material terms;
    - Has policies and procedures related to sustained use;
    - Provides loan disclosures as required by Regulation Z; and
    - Monitors or limits a borrower’s usage of payday loans on an ongoing basis.

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III. Examination Modules

- Module 4: Collections, Accounts in Default, and Consumer Reporting
  - A lender may collect a payday loan in default by:
    - Directly engaging in collection activities on its own behalf;
    - Assigning collection activity to third parties for a fee; or
    - Selling defaulted debts to a third party.
  - Fair Debt Collection Practices Act (FDCPA):
    - Examiners must assess compliance with the FDCPA when the lender is engaging in debt collection practices.
    - FDCPA does not apply to a lender collecting debts on its own behalf and under its own name.

III. Examination Modules

- Module 4: Collections, Accounts in Default, and Consumer Reporting (cont.)
  - Fair Credit Reporting Act
    - If a lender obtains a consumer report in the collection process, examiners must assess the lender's compliance with the FCRA.
  - Other Risks to Consumers – examiners must:
    - Determine whether the lender contacts borrowers in an appropriate manner.
    - Determine whether the lender makes misrepresentations or uses other deceptive means to collect debts.

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III. Examination Modules

- Module 5: Third-Party Relationships
  - Lenders sell and buy consumer information.
  - Additionally, lenders often employ and may be employed by third parties to perform services, from marketing and origination to servicing and collection activities.
  - Lenders may be responsible for the activities of third-party service providers.
  - Examiners should ensure that such lenders appropriately manage their relationships with third parties.

III. Examination Modules

- Module 5: Third-Party Relationships (cont.)
  - Gramm-Leach Bliley Act
    - GLBA requires financial institutions to disclose their privacy policies to consumers and prohibits them from disclosing nonpublic personal information about a consumer to certain third parties unless the institution satisfies notice and opt-out requirements.
    - GLBA also requires financial institutions to permit customers to opt out of certain information sharing practices with unaffiliated entities.

III. Examination Modules

- Module 5: Third-Party Relationships (cont.)
  - Fair Credit Reporting Act
    - Assess compliance with the FCRA’s affiliate marketing rule, which prohibits affiliated entities from using shared information for marketing purposes unless the consumer is given notice and opportunity to opt out and does not do so.
  - Vendor Management
    - Examiners should evaluate copies of any agreements between lenders and third parties acting on behalf of the lender for purposes of assessing risks to consumers.

IV. Questions and Answers

- Questions and Answers

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