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Spotlight On The Short-Term Credit Crackdown

Law360, New York (October 02, 2013, 5:21 PM ET) -- Short-term lending is under a new round of attacks, and this time some banks are feeling the heat. The New York State Department of Financial Services recently issued a letter to 117 banks requesting that they “choke off" automated clearing house (ACH) payment access to their customers’ accounts, and other state regulators have taken the same approach. If the loans cannot be repaid, the thinking goes, the loans will not be made in the first place and online lenders will be forced out of business.

Federal authorities may well be on a similar path. The Consumer Financial Protection Bureau published a white paper relating to payday loans in May, concluding that they are “debt traps” for many consumers, and has promised activity in the near term. Director Richard Cordray has acknowledged that the bureau is partnering with other regulators to address the role of banks in “financing and collecting the money.”

The U.S. Department of Justice is likewise concerned about this role. The executive director of the Financial Fraud Enforcement Task Force noted recently that a top priority is the financial institutions that perpetrate “fraud” and “victimize” their own customers by effecting online short-term credit transactions.

Although short-term credit products are neither illegal nor fraudulent per se, some class action plaintiffs’ firms are seizing on this regulatory dilution of the term “fraud” and hunting for clients. Plaintiff-side recruitment websites suggest that banks are about to see a flurry of new suits. One trumpets: “Banks Facilitating Illegal Internet ‘Payday’ Loans Subject to Class Action Investigation.” Another accuses “banks that debit the funds via electronic transfers” of “facilitating [ ] illegal internet payday loans.”

While the reputational harms associated with such transactions may force some early settlements, banks will likewise think twice before surrendering. While New York banking Superintendent Benjamin Lawsky has said that lenders “should know that they can’t simply hide from the law in cyberspace,” the “location” of online loan transactions for purposes of applying the law is contested, and federal law may well protect some online lenders who seek to avoid the application of tighter state usury caps.

Of greater importance, the targeted banks are not the lenders — or even parties to the transactions. While the Justice Department Task Force suggests that relatively higher return rates may be per se fraudulent, class action plaintiffs will face enormous legal hurdles in establishing unfair or fraudulent practices by banks that merely process loan repayments. Return rates reflect the percentages of ACH transactions that the customer’s bank returns unpaid or for a refund. Reasons typically include insufficient funds, an incorrect account number or lack of authorization. While high return rates may theoretically raise legitimate concern in some contexts (for example, offshore gambling), it is inherently difficult to establish culpability for the bank merely because an account holder engaged in a legal

transaction.

Return rate distribution is not an appropriate red flag for fraud in this context. The Justice Department Task Force compares an industry average return rate for ACH transactions at 1.5 percent to rates exceeding 30 percent for “deceptive payday loans” and other “mass marketing fraud schemes.” But a loan is not deceptive or fraudulent simply by operation of a return rate threshold. Credit card network disputed rates do not include transactions declined when the card is swiped. The industry has correctly figured out that a more appropriate metric is the percent of transactions disputed rather than percent declined, and the same good sense should apply to judgments about short-term lending return rates.

Notwithstanding these and other strong defenses to the class action lawsuits that are likely to come, receiving banks may wish to take stock now of their internal governance relating to lender and processor relationships. In particular, banks may wish to consider their compliance with a number of arguably relevant laws (e.g., AML/BSA and OFAC), principles set forth both in FIL-3-2012 (FDIC Payment Processor Relationships Revised Guidance), and third-party vendor management guidance, among other areas.

If class action firms advance the regulators’ view that banks may somehow be accountable for deciphering the DNA of every ACH transaction, the strength of compliance management may become as critical to the defense of private litigation as it is to regulatory supervision.

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