LexisNexis® Emerging Issues Analysis

Valerie L. Hletko and John P. Kromer on

Minifinance: CFPB Supervision of Short-Term, Small-Dollar Financial Products and Services

2012 Emerging Issues 6301

Click here for more Emerging Issues Analyses related to this Area of Law.

The Consumer Financial Protection Bureau ("CFPB") launched its nonbank supervision program on January 5, 2012, and immediately kicked off a payday lending component. Announcing its regulatory authority over payday lending, CFPB Director Richard Cordray promised to devote "much more attention" to the payday lending industry. As evidence of that, the CFPB devoted its first field hearing to payday lending issues and promptly issued examination guidelines for short-term, small-dollar loans. A month later, the CFPB announced a review of checking account overdraft programs through another highly publicized field hearing and seminar.

These CFPB initiatives demonstrate that, for the first time, depository institutions and nonbank lenders are being examined under the same federal microscope. All providers of short-term, small-dollar financial products and services, which we call "minifinance," must be scrupulously attentive to emerging rules and standards. Minifinance products, which typically provide solutions for consumers' short-term financial needs, may become harder to access as a result of forthcoming regulation and an apparent regulatory distaste for the products themselves.

The cornerstone of CFPB minifinance supervision will be enhanced supervisory attention of banks and non-banks and resulting enforcement actions based on "unfair, deceptive or abusive" acts or practices ("UDAAP"). This article reviews the guideposts already established by the CFPB and recommends industry practices for providers anticipating new rules and standards. We focus on the "abusive" prong of the new UDAAP standard, which bears on whether an act or practice:

- materially interferes with consumer ability to understand a term or condition of a product or service; or
- takes unreasonable advantage of
- a lack of consumer understanding of material risks, costs, or conditions of a product or service,
- consumer ability to protect interests in selecting or using a product or service, or
- reasonable reliance on a purveyor to act in the consumer's interest.

TOTAL SOLUTIONS
Legal Academic Risk & Information Analytics Corporate & Professional Government

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

Emerging UDAAP standards will complicate regulatory compliance efforts for minifinance providers. CFPB Director Cordray believes consumers will make "good decisions" when they "know the true, costs, benefits, and risks of competing products." But how will the agency ultimately regulate products it may never see as "good" despite its recognition that they are essential to a significant number of consumers?

Payday Lending

The fact that payday lending is a high priority for the CFPB should not be a surprise to anyone in the industry. Congress expressly included payday lending firms among the non-banks that would be subject to the CFPB's supervision as part of the Dodd-Frank Act. In a Unified Agenda entry published retroactively for the Fall 2011 issue, the CFPB included a plan for a proposed rule for registration of non-depository covered institutions, including payday lenders. A January 2012 Congressional Research Service report on the CFPB's early agenda made clear that the agency is empowered to set consistent national payday lending standards. The CFPB will focus on lenders with a high volume of transactions, particularly those operating in states with little or no payday lending oversight. It has also signaled that it will pursue providers affiliated with Native American tribes (which are exempt from state law). The CPFB also plans to broaden the reach of its payday lending initiatives through coordination with state partners on supervision and enforcement, including state regulatory agencies and state Attorneys General.

On January 19, Director Cordray led the CFPB's field hearing on payday lending in Birmingham, Alabama at which he noted the historical lack of federal supervision of the market and the "inherent risks associated with payday products." Asserting that "[n]ow the Bureau will be giving payday lenders much more attention," he reported on the CFPB's intention to "systematically gather data" about the payday market and its impact on consumers. Moreover, his comments suggested concerns with various industry practices, including repeated, long-term use of payday loans at very high APRs, unauthorized debits of borrower bank accounts, and aggressive debt collection practices.

Coincident with the January field hearing, the CFPB released its procedures for examining short-term, small-dollar lending. The guidelines lay out examination objectives and set forth five modules for examiners to complete during examinations.

- *Module 1*: Marketing. Examiners will identify lender "targets" and evaluate all advertising materials and disclosures (comparing materials in lan-

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

guages other than English with English language materials). They will also focus on incentive compensation programs and the use and compensation of lead generators.

- *Module 2*: Application and Origination. Examiners will review all application, evaluation, and origination procedures to determine their compliance with federal consumer financial laws and regulations, including the Equal Credit Opportunity Act ("ECOA") and Regulation B, the Fair Credit Reporting Act, the Truth in Lending Act ("TILA") and Regulation Z, and the Electronic Fund Transfer Act ("EFTA") and Regulation E. The focus of the review will be the consumer's thorough understanding of minifinance features throughout the life cycle based on lender statements, representations, claims, and information relating to cost, value, availability, benefits, and terms.
- *Module 3*: Payment Processing and Sustained Use. Examiners will evaluate whether options for sustained use (rollovers or back-to-back transactions) are disclosed "accurately" and "non-deceptively." They will investigate whether lenders assess income or other financial information to determine the consumer's ability to repay a loan without modification or refinancing. As in the mortgage context, ability to repay is certain to loom large in regulatory review.
- *Module 4*: Collections, Accounts in Default, and Consumer Reporting. Examiners will review whether lenders and third parties comply with the Fair Debt Collection Practices Act, and whether they utilize "deceptive means" to collect debts.
- *Module 5*: Third-Party Relationships. Examiners will focus on whether lenders have established proper Gramm-Leach-Bliley privacy safeguards—both internally and in their third-party relationships—and whether these policies are adequately disclosed to consumers.

Prior July 21, 2011 and the formation of the CFPB, the Federal Trade Commission ("FTC") held principal federal responsibility for investigating allegations of unfair or deceptive trade practices under the Federal Trade Commission Act. It retains this authority, and reaffirmed it in a January 27, 2012 annual report. As reflected in the recently released Memorandum of Understanding, the FTC and CFPB plan to (i) meet regularly to communicate and coordinate investigation, enforcement, and rulemaking activities; (ii) consult on rulemaking and guidance initiatives; (iii) cooperate on consumer education efforts; and (iv) share consumer complaints. It is clear the FTC and CFPB are coordinating closely on other issues as well, one example of which is the FTC's priority atten-

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

tion to payday loan providers with tribal affiliations (specifically, in connection with the Cheyenne River Sioux Tribe).

On March 13, 2012, Senator Merkley (D-Ore.) announced plans to introduce legislation covering online, offshore, and insured depository institution payday lending. His bill will require clear lender identification disclosures for products offered online while targeting abusive practices relating to the provision of data. It would also close loopholes in the regulation of offshore payday lenders and ensure that banks and insured depository institutions support "healthy banking practices." Senators Merkley and Akaka also have requested Director Cordray's support for state action against payday lenders. Their letter to Mr. Cordray highlights the recent increase in minifinance offerings by banks and credit unions, expressing concern about payday lending sites functioning primarily as lead generators and those structured to avoid state law.

The Merkley legislation signals interest from Congress that will likely provide further incentive for the CFPB to pursue an aggressive supervision and enforcement agenda in the payday lending industry. Banks and non-banks alike must move quickly to review their compliance performance and enhance their policies and procedures if they are to survive the enhanced scrutiny that is coming from Washington.

Overdraft Protection Programs

On February 22, 2012, a group of 250 national organizations and individual advocates sent a letter to the Federal Reserve, the CFPB, the FDIC, and the OCC urging action on short-term advances by banks. On the same day, the CFPB announced its inquiry into overdraft protection programs. From an enforcement perspective, the line between overdraft protection and short-term, small-dollar lending has become blurred. Institutions may no longer rely on the letter of statutes and regulations for determinative findings that perfectly legal practices are not potentially "abusive."

While Federal Reserve rules govern high-profile issues such as opt-in requirements for overdraft protection, they do not limit the number, frequency, or fees associated with the product. The CFPB has expressed concern about growing overdraft costs in the aggregate, and has requested data from large banks about their overdraft practices. It will focus on four principal areas:

- Transaction Ordering. The CFPB will review whether institutions order transactions (for example, from high dollar amounts to low) in a way that

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

maximizes fee income and, if so, the prevalence of such practices. Director Cordray has acknowledged that there may be legitimate reasons to pay the largest transactions first, but the effect may be to increase the number of overdraft fees. Existing guidance has focused on disclosure and emphasized that institutions should not manipulate the order of payment to inflate the number of fees. The CFPB may establish a fee-neutral rule on the subject (for example, first-in, first-out).

- <u>Disclosure of Overdraft Program Terms and Alternatives</u>. The CFPB will review whether disclosures adequately inform consumers of overdraft protection program terms and alternative options. The goal is to allow consumers to fully anticipate and potentially avoid fees. If alternative options include other types of minifinance products, institutions may face increased scrutiny of their underwriting policies and safety and soundness issues.
- <u>Marketing Materials</u>. The CFPB will review marketing materials for potentially misleading statements. It will investigate claims of misleading statements about overdraft fees, and will examine whether different explanations and advertisements for overdraft programs result in varying opt-in rates. Institutions should not suggest that overdraft protection may be a substitute for or superior to a payday loan, so as not to implicate ECOA and Regulation E's reporting and notice provisions, inasmuch as overdraft protection is not deemed "occasional" or "incidental" credit under Regulation B.
- <u>Disproportionate Impact on Certain Populations</u>. Pursuant to its authority under ECOA, the CFPB will review whether low-income and young consumers pay a disproportionate share of overdraft fees relative to other consumers.

Minifinance Best Practices

The American Bankers Association has appropriately emphasized the need for both a "uniform set of supervisory expectations" among the CFPB and other federal banking agencies and a coherent set of regulatory expectations for minifinance products subject to overlapping supervisory jurisdiction. Projected legislation and CFPB examination modules appear to target the truly abusive efforts of dishonest and predatory actors seeking to mislead or defraud consumers. Although CFPB Director Cordray has stated his recognition of the need for emergency credit and has pledged to "balance the needs of consumers with the risks they face," much of the rhetoric among legislators and regu-

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

lators has been more broadly critical of minifinance itself. Witness the language of consumer "risk" and "good" or "bad" decision-making. Indeed, even the CFPB examination procedures identify certain "risks to consumers" throughout the modules, and the CFPB has made clear that its payday lending supervision program will be risk-based. Director Cordray has frequently testified that the Bureau will not further define abusive practices by rule. Instead, it will address such practices based on "facts and circumstances" and through enforcement actions.

Minifinance provides essential relief and—sometimes—the least-bad option for consumers facing short-term financial hardship. If used correctly and as providers (and most users) intend, they result in fees far smaller than the cost of bouncing checks, carrying credit card balances, and most service fees in other industries. Regulators must ensure that they separate their evaluation of lawful, fully-disclosed practices from what appears to be visceral antipathy for one branch of a financial decision tree they ordinarily do not face.

Until a clearer definition emerges of what acts and practices are "abusive" and the CFPB's examination and enforcement agenda plays out, minifinance providers should take these steps now to minimize the chances of being targeted for enforcement:

- Review all statements, representations, disclosures, and claims relating to costs, fees, value, availability, alternatives, benefits, collection practices, terms, and lender identity to ensure clarity, prominence, and compliance with regulatory guidance.
- Limit ancillary products offered in connection with minifinance products, and ensure that the optional nature, material terms, and costs for these products are clearly disclosed.
- Document carefully all operational procedures, in particular those relating to the processes by which consumers select products.
- Establish clear policies and monitoring practices for seriality and sustained use options, possibly including caps on the number or amount of fees assessed within a set period. Review all marketing materials and communications with consumers to eliminate encouragement of routine use.
- Ensure clear and prominent disclosures about consumer payment methods.
- Establish and document policies relating to consumers' ability to repay, including limiting the amount and/or number of fees (for example, imposing

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

limits on total daily costs). With respect to overdraft protection, eliminate or reduce fees for *de minimis* overdrafts.
- Ensure proper application of payments.
- Establish and document policies (internal and third party) for collections and monitor their implementation, addressing any exceptions as they occur. Train and retrain staff periodically on collection policies.
- Develop and implement controls and testing procedures to ensure compliance with applicable laws and internal policies and procedures.
- With respect to overdraft protection, ensure proper opportunities to opt in and out of service, provide real-time alerts prior to fee assessment where feasible, distinguish clearly between balances and available overdraft protection funds, and provide clear notice of usage with each transaction. Usage notifications should include the date and type of transaction, amount of overdraft transaction, amount of overdraft fee, amount required to return the account to a positive balance, and the consequences of not doing so. Banks should also review policies relating to "forced pay" transactions, which cannot be declined, for example, due to merchant delay of settlement.

Click here for more Emerging Issues Analyses related to this Area of Law.

About the Authors. VALERIE L. HLETKO and JOHN P. KROMER are Partners in the Washington, D.C. office of BuckleySandler LLP. They represent financial services companies in compliance matters, government enforcement proceedings, regulatory examinations, investigations and litigation. Contact them at vhletko@buckleysandler.com and jkromer@buckleysandler.com.

Valerie L. Hletko is a Partner in the Washington, DC office of BuckleySandler LLP. Ms. Hletko represents financial institutions in examinations, investigations, and administrative enforcement actions initiated by the United States Department of Justice, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and state bank regulatory agencies and state attorneys general. Her enforcement practice is focused on fair lending, financial products trade practices, mortgage fraud, and mortgage loan servicing. Ms. Hletko has represented financial institutions in private class action litigation alleging violations of federal and state fair lending laws, mortgage fraud, and unfair and deceptive trade practices.

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

Ms. Hletko also counsels financial institutions on risk management, loss mitigation and residential mortgage loan modification programs, and compliance with consumer protection laws, such as the Fair Credit Reporting Act, the Fair Debt Collections Practices Act, the Real Estate Settlement Procedures Act and the Truth in Lending Act.

Ms. Hletko lectures and publishes on subjects of interest to financial institutions, including the management of litigation and regulatory risk in light of outsourcing and False Claims Act litigation and enforcement trends.

Prior to joining BuckleySandler LLP in 2009, Ms. Hletko was an associate attorney with Skadden, Arps, Slate, Meagher & Flom LLP. From 2001-2003, she was an associate attorney with Paul, Weiss, Rifkind, Wharton & Garrison LLP.

John P. Kromer, co-managing partner of BuckleySandler LLP, advises clients on compliance with state and federal laws applicable to mortgage companies, consumer finance companies, real estate companies, commercial lenders and other financial institutions. He assists financial services firms to develop, structure and negotiate business relationships, including joint ventures and outsourcing arrangements. He also advises financial and strategic purchasers of financial services firms in connection with regulatory matters, including due diligence of companies, assets and portfolios.

Mr. Kromer is the Chair of the Housing Finance and RESPA Subcommittee of the Consumer Financial Services Committee of the Business Law Section of the American Bar Association and serves on the Advisory Council of the American Association of Residential Mortgage Regulators.

Mr. Kromer is a frequent panelist at industry conferences discussing legal issues affecting mortgage companies and consumer lenders. He is a co-author of books including *Residential Mortgage Lending: State Regulation Manual; Residential Mortgage Lending: Brokers; Pratt's State Regulation of Second Mortgages and Home Equity Loans; Mortgage Bankers Guide to Regulatory Compliance;* and *The Law of Electronic Signatures and Records*, and has written numerous articles for consumer financial services industry publications.

Before joining BuckleySandler, Mr. Kromer was a partner with Goodwin Procter LLP and, prior to that, a partner with Negroni & Kromer, PLLC. Prior experience includes work as a legislative assistant to U.S. Representative Larry J. Hopkins (KY) from 1988-

TOTAL SOLUTIONS

Legal Academic Risk & Information Analytics Corporate & Professional Government

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.

1990 for banking, housing, budget and tax issues, and as a legislative intern to Virginia State Senator Edgar Robb from 1992-1993.

Emerging Issues Analysis is the title of this LexisNexis® publication. All information provided in this publication is provided for educational purposes. For legal advice applicable to the facts of your particular situation, you should obtain the services of a qualified attorney licensed to practice law in your state.

LexisNexis, Lexis and the Knowledge Burst logo are registered trademarks of Reed Elsevier Properties Inc., used under license. Matthew Bender is a registered trademark of Matthew Bender Properties Inc.