Payment processors targeted in payday lender enforcement

Payday lending in the US is a growing industry that presents a number of opportunities for traditional financial institutions, as well as lessons to be learned from active regulatory enforcement. Katherine Armstrong and Mark W. Brennan of Hogan Lovells discuss the US payday lending industry and associated regulatory landscape, as well as recent enforcement actions - including one involving payment processors - and key takeaways for organisations participating in the payday lending market.

Payday loans are generally used by consumers who are unable to borrow money from traditional financial institutions. They are usually short-term loans, generally for $500 or less, and are typically due by the borrower's next pay check. Payday loans are marketed as helping, for example, to bridge a cash flow shortage between paychecks. Although payday lenders are typically located within the borrower's community, on a nationwide basis there are more than two payday lending storefronts for every Starbucks location. The typical payday loan is not a one-time loan but is instead 're-upped' multiple times. On average, a borrower takes out eight loans of $375 each per year and spends $520 on interest[1].

A number of regional or national lenders provide only payday loans, and some multi-service lenders offer fringe banking services. Banks are also becoming more active in the payday lending industry, including by providing capital to payday lenders and entering into partnerships.

Regulatory enforcement

There currently is no federal law addressing payday lending, but some states have adopted specific payday lending laws. Although interest rates are generally not regulated at the federal level, most states have usury laws that set limits on interest rates for loans of a certain duration. Lenders often can offer different consumers different interest rates or loan terms based on the estimated risk that the consumers will fail to pay back their loans, although a number of federal laws and regulations attempt to ensure that consumers are not discriminated against when applying for a loan (e.g., the Equal Credit Opportunity Act). In addition, federal regulations attempt to ensure that there is transparency and fairness in the lending process. For example, the Risk Based Pricing rules require creditors to provide consumers with a notice when, based on the consumer's credit report, the creditor provides credit to the consumer on less favourable terms than it provides to other consumers[2].

The Federal Trade Commission

The Federal Trade Commission ('FTC') enforces a variety of laws to protect consumers in the payday lending area and has filed many law enforcement actions against payday lenders for, among other things, engaging in deceptive or unfair advertising and billing practices and conditioning credit on the preauthorisation of electronic fund transfers. The FTC has also challenged companies that charge consumers undisclosed fees.

Some payday lenders have moved online. In a complaint filed in December, the FTC challenged the practice of data brokers that purchased online payday loan application information and sold the application information to both lenders and non-lenders, sometimes multiple times. According to the complaint, from 2006 to 2013 the defendants sold 95% of the applications for approximately 50 cents each, sometimes multiple times, to non-lender third parties - some of which the defendants allegedly knew were engaged in fraud. Specifically, the complaint alleges that the individual who controlled the corporations was aware that one of the entities that purchased the application information was engaged in a fraudulent billing and debiting scheme[3].

The Consumer Financial Protection Bureau ('CFPB')

The CFPB has also brought numerous law enforcement actions against payday lenders. In a recent action, the CFPB filed a complaint and obtained a temporary restraining order and asset freeze against the leaders of a robocall phantom debt collection operation, their companies, and their service providers. Though not focused specifically on payday lenders, the action highlights the CFPB's focus on curbing aggressive practices. According to the complaint, the defendants purchased consumers' personal information from debt brokers and lead generators and used a telemarketing firm to send robocalls to millions of consumers. In response to the debt collectors' threats and false statements, consumers provided credit or debit card payment information. The complaint further alleged that once the debt collectors obtained the consumers' payment information, they would submit it to the payment processors, who enabled the collectors to access consumers' bank accounts to withdraw money, despite indications of misconduct. The payment processors are alleged to have ignored numerous red flags that should have alerted them to the illegal conduct of the debt

collectors. This action is currently being litigated[4].

CFPB payday lending proceedings

Unlike the FTC, the CFPB has examination and rulemaking authority over payday lenders. On 26 March 2015, the CFPB outlined proposals that attempt to address some of the alleged abuses that occur in the 'short-term' payday lending marketplace. The proposals include 'prevention' and 'protection' requirements. The proposals would apply to 'short-term' loans of 45 days or less. Lenders could choose which set of requirements to follow. The CFPB is soliciting feedback on these 'outline' proposals, after which it is expected to issue formal proposed rules for public comment.

Under the proposed prevention requirements, lenders would have to determine at the outset of each loan that the consumer is not taking on 'unaffordable' debt. Specifically, the lender would have to make a reasonable determination that the consumer could repay the loan when it becomes due without defaulting or re-borrowing. This requirement would apply to the entire loan, including the principal, interest, and any add-on products. Lenders would have to affirmatively verify the consumer's income, major financial obligations, and borrowing history, and would have to determine whether the consumer can cover the loan payments while still meeting other obligations and having money for living expenses.

Under the proposed protection requirements, lenders would have to comply with various restrictions that are applicable throughout the life of the loan and are designed to ensure that consumers can affordably repay their debt. The CFPB has proposed two protection alternatives: (1) decreasing the principal amount for subsequent loans so that the debt can be paid off after three loans, after which a 60 day cooling-off period would kick in; and (2) in situations for which the borrower cannot repay the loan after two rollovers, providing an 'off ramp' no-cost extended payment plan followed by a 60 day cooling-off period. Under both approaches, loans would be capped at $500 and lenders would be prohibited from taking a security interest in a vehicle title. Lenders also could not keep a consumer indebted for more than 90 days in a 12 month period.

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Opportunities for traditional lenders and lessons learned

There are significant opportunities for traditional lenders to engage in the $27 billion payday lending market. For example, they could facilitate additional loan options for consumers without creating excessive risk or administrative costs, especially if certain data analytics or risk-based pricing metrics are considered.

Financial institutions should also examine the experiences of states like Colorado[5], or the CFPB's proposals, to determine whether there are opportunities to compete with payday lenders. For example, offering an installment plan instead of a short-term loan, and incorporating the borrower's ability to repay the loan, could appeal to a number of consumers. Consumers could also benefit from obtaining longer term installment loans to help establish traditional credit histories.

Given the increasing regulatory activity by the CFPB and the continued law enforcement activity of the FTC, financial institutions should ensure that their practices comply with existing laws. For example, they should examine marketing materials and contracts to ensure that material terms and conditions are clearly and conspicuously disclosed (e.g., all fees, penalties, late payments, or other potential expenses). If purchasing leads from data brokers or others, they should understand the source of the data and the circumstances under which it was obtained from the consumer. In addition, loans for which repayment is linked to a consumer's depository account should clearly and conspicuously disclose the consequences of not maintaining sufficient funds to avoid being overdrawn.

Payment processors should be alert to signs that the companies they work with may be engaged in illegal or fraudulent conduct. They should also consider exercising additional diligence by, for example, utilising contractual audit provisions and reviewing their partners' consumer-facing communications. Financial institutions should also keep abreast of new developments in the CFPB's payday lending proceedings and assess the extent to which any new rules may apply to existing or proposed practices.

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1. http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf
2. http://www.ecfr.gov/cgi-bin/text-idx?node=16:1.0.1.6.74&rgn=div5
3. https://www.ftc.gov/news-events/press-releases/2014/12/ftc-charges-data-broker-facilitating-theft-millions-dollars
4. http://consumerfinance.gov//newsroom/cfpb-sues-participants-in-robo-call-phontom-debt-collection-operation/
5. In 2010, Colorado enacted a law that eliminated lump sum repayments, the hallmark of a payday loan. The law requires all loans to be repayable over time.