

# Banks, Credit Unions and Payday Lending Examinations and Investigations

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Banks, credit unions and other consumer lenders that offer short-term loans and financial products (or payday-like loans) should take notice. The Financial Deposit Insurance Corporation (FDIC), the Federal Trade Commission (FTC) and the Consumer Financial Protection Bureau (CFPB) are working together along with other federal agencies to examine payday lending practices, including such practices conducted by banks and credit unions.

This publication is a brief discussion of the challenges banks and credit unions may face under heightened scrutiny by the CFPB and FDIC and steps to take in anticipation of a CFPB examination and any subsequent investigations. So far, the CFPB has focused on non-bank payday lenders in its attempt to fairly regulate “both banks and the nonbank firms that directly compete against one another in many of the same markets.”<sup>1</sup> But the CFPB is clear that consumer products provided by banks and credit unions will receive the same scrutiny.

## FDIC’s Heightened Scrutiny of Bank Payday Lending Activities

In a May 29, 2012 letter to a coalition of consumer groups, FDIC Acting Chairman Martin Gruenberg explained that the “FDIC is deeply concerned about these continued reports of banks engaging in payday lending activities and the expansion of payday lending activities under third-party arrangements.”<sup>2</sup> He noted the FDIC’s 2005 and 2007 guidance was “designed to limit bank payday lending and to encourage banks to offer affordable small dollar loans.” He concluded that “the FDIC’s Division of Depositor and Consumer Protection [will] make it a priority to investigate reports of banks engaging in payday lending and recommend further steps by the FDIC.” Consumer groups have been quick to link payday lending with overdraft programs, citing the FDIC’s 2008 study (and the 2010 guidance) regarding overdraft fees.

The FDIC and FTC will be working with the newly created CFPB in such investigations. The CFPB is taking the lead in establishing policy for payday loans. As a part of this process the CFPB will determine what payday loan (and other short-term financial products, such as direct-deposit loans) practices may violate existing federal consumer protection laws and evaluate whether any “unfair, deceptive, or abusive acts or practice” (which the agency refers to as UDAAP) is occurring. Statements from CFPB Director Richard Cordray and others indicate that while the CFPB may not initially use its rulemaking power to decide which payday lending practices are acceptable or to create safe harbors, the CFPB may instead utilize its enforcement authority to create federal precedents about what practices it considers unfair or abusive. This makes it difficult for banks that engage in short-term lending to ensure compliance.

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<sup>1</sup> Remarks by CFPB Director Richard Cordray before the 2012 Simon New York City Conference, May 3, 2012: <http://www.consumerfinance.gov/speeches/prepared-remarks-by-richard-cordray-before-the-2012-simon-new-york-city-conference/>

<sup>2</sup> <http://www.responsiblelending.org/payday-lending/policy-legislation/regulators/Bank-DDA-FDIC-OC12-65R-1.pdf>

## Payday Lending Examinations – a Top Priority

Created under the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, the CFPB has made the examination and regulation of payday lending a top priority. On January 19, 2012 the CFPB officially began the examination of the payday lending industry by hosting a field hearing in Birmingham, Alabama. At the hearing a number of questions were raised, including:

- Does the impact of payday loans and deposit-advance products vary by the type of consumer?
- Who is helped and who is harmed by deposit-advance and payday products?
- Does the answer vary depending on whether the product is provided by a storefront, a bank or online?
- How are small-dollar loans and products marketed?

The CFPB received more than 500 comments on this hearing, including those from various trade associations, payday lenders and individuals. The comments and transcript are posted on the CFPB's website.<sup>3</sup> At the same time, the CFPB began official examinations of traditional payday lenders and their affiliates (with formal investigations and enforcement likely to follow).

### “Abusive” Practice

In its examinations the CFPB is interested in any unfair and deceptive act or practice the payday lender may be engaged in as a potential violation of the Dodd-Frank Act. The CFPB further clarifies that a lending practice is considered “abusive” if it:

- (i) materially interferes with a consumer's ability to understand the product or service
- or (ii) takes unreasonable advantage of the consumer's lack of understanding, inability to protect his or her interests, or unreasonable reliance on a covered person to act in the interests of the consumer.<sup>4</sup>

At this time the CFPB offers no guidance on what activities fall into this category or actions it might take to curtail such abusive practices. Unless the agency changes its current stance, banks and credit unions may not learn the answers to these questions except through expensive enforcement proceedings.

### CFPB's Rulemaking Authority

After the comment period, the CFPB's director can issue rules that may regulate certain aspects of payday lending. Under the Dodd-Frank Act, any such regulations would create a national baseline – state laws on the subject would be preempted except for those that were stricter than the CFPB's rules. The CFPB could also affect payday lending by creating new implementing regulations for the Equal Credit Opportunity Act, the Fair Credit Billing Act, the Fair Credit Reporting Act and the Truth in Lending Act.

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<sup>3</sup> Request for Comment on Payday Lending Hearing Transcript (Regulations.gov; Docket ID: CFPB-2012-0009): <http://www.regulations.gov/#!docketDetail;dct=PS;rpp=25;so=ASC;sb=organization;po=100;D=CFPB-2012-0009>

<sup>4</sup> *CFPB Supervision and Examination Manual*, pg. 52

## CFPB Examination Process

The CFPB is currently conducting examinations of payday lenders both to evaluate their compliance with federal law, including their systems that monitor compliance, and to gather data on current industry practices. The CFPB has published two comprehensive manuals for examiners. Both are accessible on the CFPB's website. The first manual, *Supervision and Examination Manual*, focuses on the examination procedures, developed under the auspices of the Federal Financial Institutions Examination Council (FFIEC).<sup>5</sup> The second manual, *CFPB Examination Procedures: Short-Term, Small-Dollar Lending*, focuses specifically on payday lender examinations, including five broad subjects: 1) marketing, 2) origination, 3) loan rollover, 4) collections and 5) third-party relationships. The examinations may include review of broad categories of documents.<sup>6</sup> Banks and credit unions offering short-term financial products should be aware that CFPB enforcement lawyers may accompany CFPB examiners during examinations.

Prior to an examination, a lender will receive a written notice from the CFPB alerting it that it has been identified for examination. The examinations begin with a request that the lender produce various materials, and continue with on-site examinations that can include interviews with employees, customers and management. While reviewing the payday examination manual may be useful to lenders facing an examination, there is no guarantee that its recommendations will be followed by individual examiners. Aside from informal negotiations with the examiner, there is no process for objecting to any portion of an examination. Lenders should expect that their procedures for ensuring compliance with federal consumer protection laws and their compliance with those laws will be closely examined.

At the end of the examination, the CFPB will provide the lender with a confidential risk assessment report detailing the potential for the bank's practices to cause consumers to suffer any legally cognizable injury, including invasion of privacy, through violations of federal consumer protection laws. The lender cannot share these confidential reports outside of its employees, parent companies and agents.

## Privileged Documents in Government Investigations

Many courts have held that voluntary disclosure to a government agency, even pursuant to a formal investigation, will waive the attorney-client and work-product privileges. Though the CFPB asserts that privileged documents are not exempt from its examinations, it is unclear whether disclosure would waive privilege. The CFPB adopted a new rule on July 5, 2012, stating that the privilege will "not [be] affected by disclosure to the CFPB," but it is not clear whether this would be enforceable against third parties in state court.<sup>7</sup> A bill dealing with this privilege problem passed the House on March 26, 2012, but is currently stalled in the Senate. Payday lenders faced with a demand for privileged documents should consult with counsel on this issue to ensure the privilege is not waived as to third parties.

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<sup>5</sup> *CFPB Supervision and Examination Manual*: [http://www.consumerfinance.gov/wp-content/themes/cfpb\\_theme/images/supervision\\_examination\\_manual\\_11211.pdf](http://www.consumerfinance.gov/wp-content/themes/cfpb_theme/images/supervision_examination_manual_11211.pdf)

<sup>6</sup> *CFPB Examination Procedures: Short-Term, Small-Dollar Lending*: <http://files.consumerfinance.gov/f/2012/01/Short-Term-Small-Dollar-Lending-Examination-Manual.pdf>

<sup>7</sup> CFPB's Final Rule on Confidential Treatment of Privileged Information (July 5, 2012): <https://www.federalregister.gov/articles/2012/07/05/2012-16247/confidential-treatment-of-privileged-information#h-4>

## CFPB Investigations

CFPB investigations will be more limited in scope. Investigations may be conducted with other regulators and may have many features of an SEC or FTC investigation. An investigation begins when the CFPB issues a demand that identifies the federal consumer protection law that it believes the payday lender has violated, and the target must provide a sworn response and discovery. Individuals interviewed during an investigation have the right to counsel and can maintain the attorney-client privilege. The target of an investigation can also petition to set aside the demand. Investigations can close without further action, or can result in an enforcement action in federal court, in state court or in the agency's own administrative adjudication process.

**Freedom of Information Act (FOIA).** The agency has stated that information gathered during investigations will be non-public, but information from investigations will be subject to the FOIA. Exemption 8 to the FOIA exempts information "contained in or related to examination, operating, or condition reports prepared by, on behalf of, or for the use of an agency responsible for the regulation or supervision of financial institutions." This exemption should apply to information disclosed in a CFPB examination (though the CFPB has so far declined to publicly take this position, creating some worries). However, the CFPB's interim final regulations explicitly provide that documents obtained during its investigations are open to FOIA requests. The agency can also disclose the existence of an investigation to any third party during the investigation itself.

## CFPB Enforcement Actions

If the CFPB decides that a bank is not in compliance with federal consumer law, it can initiate actions in federal or state court. The agency can also use its own internal adjudicatory procedure, which is modeled on the SEC's approach. These adjudications contain some of the procedural trappings of a lawsuit, but lack many protections for the target entity. While the agency will have already conducted an examination or investigation to gather the needed materials, the rules do not generally allow the target entity to conduct discovery, such as depositions or interrogatories. And although the target of an action has only 14 days to file its answer, the regulations state that extensions of time are "strongly disfavored." The hearing officer has significant discretion in making decisions, but the agency's director has final say over all decisions.

If the agency determines there is a violation of federal law (or the agency's own rules and orders), the hearing officer has the power to rescind or reform contracts, issue injunctions, order a regulated entity to refund money or take other affirmative actions, and can impose significant monetary penalties. An administrative proceeding can result in civil penalties of US\$5,000/day for violating federal consumer laws, US\$25,000/day for a reckless violation or US\$1,000,000/day for a knowing violation. These powers are significantly greater than those enjoyed by other regulators.

## Next Steps

Banks and credit unions offering short-term loans akin to payday loans should stay abreast of the CFPB's regulations and any investigations, enforcement proceedings or lawsuits filed by the CFPB or other regulatory agencies (such as the FTC) against non-bank payday lenders. In addition, now that the FDIC and CFPB have made examination of payday lending practices a priority, adherence to the following guidelines is more important than ever:

- Lenders should put into place thorough procedures to ensure compliance with federal law.
- Lenders should ensure that compliance is properly documented.
- Lenders should pay particularly close attention to their collection practices (and the practices of any third party they utilize) and to online lending practices.

## Payday Examinations in the UK

Banks and credit unions engaging in payday lending should also be aware that the UK Office of Fair Trading (OFT) is conducting a similar examination of the payday industry, payday lenders and their affiliates. While the OFT's examinations are separate from the CFPB, the two agencies are, no doubt, watching one another's progress. Our UK Financial Services Litigation Practice is actively monitoring the OFT, as such examinations and subsequent rules may impact Squire Sanders' payday lender clients that have interests in the UK and European countries governed by UK law.

For more information on the OFT and its examination of payday lenders in the UK, please visit the Financial Services Litigation page on Squire Sanders' website:

<http://www.squiresanders.com/financial-services-litigation/>.

For more information on the CFPB and payday lending examinations, investigation and enforcement, please contact:

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