

Examination Procedures

Short-Term, Small-Dollar Lending Commonly Known as Payday Lending

These examination procedures apply to the short-term, small-dollar credit market, commonly known as payday lending. The procedures are comprised of modules covering a payday loan's lifecycle, and each module identifies relevant matters for review. Prior to using the procedures, however, examiners should complete a risk assessment and examination scope memorandum. Depending on the scope, and in conjunction with the compliance management system and consumer complaint response review procedures, each examination will cover one or more of the following modules:

1. Marketing
 2. Application and Origination
 3. Payment Processing and Sustained Use
 4. Collections, Accounts in Default, and Consumer Reporting
 5. Third-Party Relationships
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Examination Objectives

In consultation with headquarters:

1. To assess the quality of the regulated entity's compliance risk management systems, including its internal controls and policies, for its payday lending business.
2. To identify acts or practices that materially increase the risk of violations of federal consumer financial laws in connection with payday lending.
3. To 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. To determine if a violation of a federal consumer financial law has occurred and whether supervisory or enforcement actions are appropriate.

Background

Lenders typically market payday loans to consumers as a means of bridging a cash-flow shortage between pay or benefits checks. Payday loans generally have three features: the loans are small-dollar; borrowers must repay loan proceeds quickly (i.e., they are short-term); and they require that a borrower give lenders access to repayment through a claim on the borrower's deposit account.

Other loan features vary. Although often structured to pay off in one balloon payment, installment payments and interest-only payments are not unusual. Loans may be open-end or closed-end, and although loans are commonly issued for terms under one month, others may have terms for as long as six months. Loans may be disbursed in cash, on a prepaid card, through the Automated Clearing House ("ACH") network, or by check.

Most loans are for several hundred dollars and have finance charges of \$15 to \$20 per each \$100 borrowed. For the two-week term typical of a payday loan, these fees equate to an Annual Percentage Rate ("APR") ranging from 391 percent to 521 percent. Loan amounts and finance charges can vary due to factors including differences in state law.

Although lenders sometimes access third-party data about their customers, lenders generally do not underwrite their applicants using traditional credit criteria. Because consumers provide lenders with access to their bank accounts in advance – through, for example, a personal check in the amount of the outstanding balance (i.e., loan amount and finance charge) owed – consumers typically need only a regular source of income and a checking account in good standing to qualify.

If the consumer does not repay the loan in full by the due date, the loan agreement typically permits the lender to deposit the consumer's check to obtain payment. In the case of a web-originated loan, the loan agreement typically preauthorizes repayment through an electronic debit transaction (such as an ACH transaction). Store-front lenders may use ACH transactions as well.

Some banks market a payday loan variant they call an "advance" – a direct deposit advance, an early access advance, a ready advance, or a checking account advance¹. A typical credit line is \$500 and costs \$10 per \$100 borrowed. To qualify for an advance, a consumer must have a deposit account with the bank or credit union offering the advance and a recurring direct deposit of funds into that deposit account. The loan and accompanying fee generally must be repaid through the consumer's next direct deposit of funds or within 35 days of the extension of credit. Once repaid, the line is replenished, and consumers are able to obtain additional funds without further application.

¹ For clarity, this product is neither an overdraft line of credit nor an overdraft service. An overdraft service means a service under which a financial institution assesses a fee or charge on a consumer's account held by the institution for paying a transaction (including a check or other item) when the consumer has insufficient or unavailable funds in the account.

Regardless of the channel used by lenders to conduct business – whether through a third-party lead generator, online, through a brick and mortar location, by mail, or by telephone – the following federal consumer financial laws and regulations apply to payday loans:

- The Truth in Lending Act (TILA) and its implementing regulation, Regulation Z, require lenders to disclose loan terms and Annual Percentage Rates. Regulation Z also requires lenders to provide advertising disclosures, credit payments properly, process credit balances in accordance with its requirements, and provide periodic disclosures. Note that the requirements for open- and closed-end loans differ.
- The Electronic Fund Transfer Act (EFTA) and its implementing regulation, Regulation E, protect consumers engaging in electronic fund transfers. Among other things, Regulation E prohibits lenders from requiring, as a condition of loan approval, a customer's authorization for loan repayment through a recurring electronic funds transfer (EFT), except in limited circumstances.
- The Fair Debt Collection Practices Act (FDCPA) governs collection activities conducted by: (1) third-party collection agencies collecting on behalf of lenders; (2) lenders collecting their own debt using an assumed name, to suggest that a third person is collecting or attempting to collect such debt; and (3) any collection agency that acquires the debt if the collector acquired the debt when it already was in default.
- The Fair Credit Reporting Act (FCRA) and its implementing regulations require that furnishers of information to consumer reporting agencies ensure the accuracy of data placed in the consumer reporting system. Additionally, the FCRA prohibits the use of consumer reports for impermissible purposes, and it requires users of consumer reports to provide certain disclosures to consumers. The FCRA also limits certain information sharing between affiliated companies. Examiners should note that the FCRA's implementing regulations may differ for depository and non-depository institutions.
- The Gramm-Leach-Bliley Act (GLBA) and its implementing regulations prevent financial institutions from impermissibly sharing a consumer's nonpublic personal information with third parties, and it requires that financial institutions disclose their privacy policies. Examiners should note that the GLBA's implementing regulations may differ for depository and non-depository institutions.
- The Equal Credit Opportunity Act (ECOA) and its implementing regulation, Regulation B, set forth requirements for accepting applications and providing notice of any adverse action, and they prohibit discrimination against any borrower with respect to any aspect of a credit transaction:
 - On the basis of race, color, religion, national origin, sex or marital status, or age (provided the applicant has the capacity to contract);
 - Because all or part of the applicant's income derives from any public assistance program; or

- Because the applicant has in good faith exercised any right under the Consumer Credit Protection Act.

To carry out the objectives set forth in the Examination Objectives section, examiners also should assess other consumer risks, including potentially unfair, deceptive, or abusive acts or practices (UDAAPs) with respect to lenders' interactions with consumers. The standards the CFPB will use in assessing UDAAPs are:

- 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.
- 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.
- 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.

Refer to the examination procedures regarding UDAAPs for more information about the legal standards and the CFPB's approach to examining for UDAAPs. The particular facts and circumstances in a case are crucial to the determination of UDAAPs. Examiners should consult with headquarters to determine whether the applicable legal standards have been met before a UDAAP violation is cited.

General Considerations

Completing the following examination modules will allow examiners to develop a thorough understanding of lenders' practices and operations. 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; 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.

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 headquarters, examiners may also consider using customer surveys.

Module 1: Marketing

Examiners should develop a detailed understanding of the lender's marketing program to determine whether its marketing policies, procedures, and practices are consistent with the requirements of applicable federal consumer financial laws and regulations.

- Identify a lender's marketing targets and its methods for reaching those targets.
- Evaluate the lender's advertising materials and disclosures across all media, including: print, television, radio, telephone solicitation scripts, and electronic media including the Internet, email, and text messages. The evaluation should include a review of advertising materials provided in languages other than English, the media used to distribute those materials, and a comparison to English language materials and 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.

Advertising Requirements

Truth in Lending Act/Regulation Z

1. Determine whether the loans being offered are closed end or open end.
2. Determine whether the lender's advertisements are consistent with the requirements of Regulation Z. Examiners should conduct the advertising review by following the open- and closed-end advertising procedures in the TILA examination procedures, as applicable, focusing carefully on whether advertisements contain triggering terms and include required statements, information, and disclosures.

Equal Credit Opportunity Act/Regulation B

1. Assess how the lender reaches its potential customers through its statements, advertising, or other marketing representations. Examiners should review:
 - a. Marketing and advertising materials, including signs or other displays and prescreened solicitations;
 - b. The criteria used to determine the potential recipients of the particular solicitation;
 - c. Any scripts and interview forms used for sales and taking applications; and
 - d. Product information used in discussing available types of credit with applicants.

Other Risks to Consumers

1. Assess whether the lender clearly and prominently discloses the material terms of the payday loan.
2. Determine whether the promotional materials clearly and prominently disclose any material limitations, conditions, or restrictions on the offer. This is of particular importance when the lender uses terms such as “rewards,” “discounts,” or “free.”
3. Assess (i) whether the lender clearly and prominently discloses the costs and any other material terms for any additional products marketed to the consumer (e.g., pre-paid debit card or credit insurance) in connection with the payday loan; and, (ii) whether the lender clearly and prominently discloses that the additional products are or are not required to obtain credit and are or are not considered in decisions to grant credit. If the cross-marketed product is mandatory, under the TILA, it may need to be disclosed in the APR. Refer to the TILA examination procedures for additional detail.
4. Determine whether the lender reviews or monitors recorded telephone calls, transcripts of online communication, and websites to ensure that advertising and solicitations comply with applicable federal consumer financial laws.

Compensation Practices

Evaluate compensation practices and programs. 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. Evaluate the quality and impact of controls on the compensation program. Finally, in consultation with headquarters, assess whether the program incentivizes behaviors or practices that result in heightened risk to consumers.

Lead Generation

Lenders both employ and are employed as lead generators, which are businesses that identify potential borrowers for lenders. A lead generator typically charges lenders for its services and in some cases, may charge borrowers as well. Some lenders operate as lead generators when they are unable to originate a particular loan – when, for example, they are not licensed to originate loans in a particular state. In these instances, the lead generator will contract with another lender that is able to make the loan.

When examining lenders, examiners should:

1. Identify whether the lender is, or uses, a lead generator and, as applicable, review the advertising materials of:
 - a. Lead generators or brokers employed by the lender.
 - b. The lender, in its capacity of lead generator or broker.

2. Determine whether the nature of the relationship between the parties is clearly disclosed, including whether the lead generator or broker represents to consumers that it is working on behalf of third-party organizations and whether the new lender is identified when referred to another party.
3. Determine whether the statements and representations made by a company on another's behalf are accurate and non-deceptive.
4. Determine whether all fees for referred services are appropriately disclosed to consumers.

To the extent set forth in the scoping memorandum, examiners should further evaluate any third-party relationships under the provisions of the vendor management, privacy, and information sharing sections in the Third-Party Relationships Module.

Module 2: Application and Origination

When lenders take applications, evaluate applicants, and originate payday loans, they are subject to the disclosure and other legal requirements discussed below. Examiners should identify acts, practices, or materials that indicate potential violations of federal consumer financial laws and regulations.

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

As noted previously, lenders typically do not access traditional credit reporting agency data. However, alternative third-party data providers may be consumer reporting agencies, as defined by the FCRA. Lenders that obtain information from a consumer reporting agency to determine a consumer's credit worthiness must comply with the requirements of FCRA. When a lender does not offer a loan or provides a loan on materially less favorable terms to a consumer (e.g., charging a higher interest rate) because of the consumer report information it obtains, the lender must provide appropriate adverse action or risk-based pricing notices to the consumer. Examiners should refer to the CFPB's FCRA examination procedures for additional information.

Truth In Lending Act/Regulation Z

1. Determine whether the loans being offered are closed-end or open-end.
2. 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. Examiners should use the TILA/Regulation Z examination procedures to evaluate the lender's compliance with the open- and closed-end disclosure requirements of Regulation Z, as may be applicable depending on the products offered by the lender.
3. Examine the loan product to verify that the product being offered conforms to the lender's representations or to determine if the lender has mischaracterized or misclassified its product and therefore is not complying with the proper set of requirements (e.g., the lender characterizes its loan product as closed-end where the product in fact is open-end, and the lender should be complying with TILA/Regulation Z's requirements for open-end credit).
4. For refinanced loans, determine whether the appropriate disclosures are being provided by the lender.

Electronic Fund Transfer Act/Regulation E

Depending on how the lender transfers funds to and from consumers, the lender may be required to comply with the requirements of the EFTA. 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.

1. Determine if the agreement contemplates or involves initiating an electronic fund transfer subject to EFTA/Regulation E ("EFT"). Consider if the lender is using methods subject to EFTA or using remotely-created checks or other non-EFT methods, which are not subject to EFTA.
2. Determine whether the EFT is a single or a recurring EFT that is a preauthorized electronic transfer. To qualify as a preauthorized electronic fund transfer, the transfer is one that is authorized in advance to recur at substantially regular intervals.
3. If the lender initiates preauthorized EFTs, assess the lender's or financial institution's compliance with the applicable advance authorization, disclosures, and other requirements relating to preauthorized electronic fund transfers under the EFTA and Regulation E.
 - a. Does the lender obtain proper written authorization for preauthorized electronic fund transfers from a consumer's account and provide a copy of the authorization to the consumer?
 - b. Does the lender require compulsory use of EFTs and condition the extension of credit to consumers on the repayment of loans by preauthorized electronic debits?
 - i. Examine the agreement for terms requiring that the borrower agree to electronic payment. Such terms may violate the EFTA's prohibition on requiring repayment by means of preauthorized electronic fund transfers as a condition of the extension of credit, except as authorized.
 - ii. Determine if the lender offers the borrower an option to pay using a non-EFT method of payment.
 - c. Will the preauthorized transfers vary in amount? If so, does the payee or financial institution, prior to each transfer, provide reasonable advance notice to the consumer, in accordance with applicable regulations, of the amount to be transferred and the scheduled date of transfer?
4. If the loan agreement provides for a single or one-time EFT, assess whether the lender obtained authorization from the consumer to initiate an EFT.

Other Risks to Consumers

1. Determine whether, in the application and origination process, the lender makes statements, representations, or claims, or provides information to consumers that may mislead the consumer regarding the cost, value, availability, cost savings, benefits, or terms of the product or service.
2. Determine whether the lender accurately and non-deceptively represents the amount of potential, approved, or useable credit that the consumer will receive.
3. Determine whether the lender clearly and prominently discloses its funds disbursement practices, including:
 - a. Whether the lender clearly and prominently discloses all fees that the borrower might incur to gain access to loan funds. For example:
 - i. If the lender disburses funds by check, does the lender disclose its check cashing fee?
 - ii. If the lender disburses funds by prepaid debit card, does it disclose its ATM access fee?
4. Determine whether the lender offers additional products or services, either related or unrelated to the payday loan in connection with the payday loan. If yes:
 - a. Determine whether the lender clearly and prominently discloses material terms of the optional product or service, including costs.
 - b. Determine whether the lender receives and documents the consumer's express authorization prior to adding optional products or services to the payday loan.
 - c. Review to ensure authorizations were provided and documented. Review methods of obtaining authorization to ensure that customer affirmatively selects product.
5. Determine whether the lender discloses its repayment and collection practices.
6. Determine whether the lender clearly and prominently discloses the consumer's rights regarding payment methods.
7. In assessing application risks to consumers, examiners may find evidence of violations of – or an absence of compliance policies and procedures with respect to – other laws applicable to payday lending, such as the Military Lending Act. In these circumstances, examiners should identify such matters for possible referral to federal or state regulators or other appropriate action.

Module 3: Payment Processing and Sustained Use

As set forth in the examination scope memorandum, examiners should review a sample of customer accounts for the following issues:

Truth In Lending Act/Regulation Z

1. Determine whether the loans being offered are closed-end or open-end.
2. 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

1. Determine whether the lender is complying with the appropriate disclosure requirements if the lender is converting check payments from borrowers to electronic fund transfers.
2. Determine whether the lender is complying with the appropriate disclosure requirements if the lender is collecting returned item fees by electronic fund transfer.

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. This is often called a back-to-back transaction. All of these borrowing patterns may constitute sustained use. Note that in some instances, lenders may allow borrowers to convert a balloon payment into an installment plan.

Examiners first should determine whether the lender offers any of the above options. If yes, then:

1. Determine whether the lender represents accurately and non-deceptively the payment options that will be available to borrowers.
2. Determine whether the lender provides borrowers with all available repayment options offered by the lender.
3. Determine whether the lender discloses clearly and prominently all fees and material terms associated with the sustained use transactions.
4. Determine whether the lender has policies and procedures related to sustained use of the loan product and whether the lender is adhering to its policies.

5. If a sequential transaction is considered a refinance, determine whether the lender provides loan disclosures as required by Regulation Z.
6. If a consumer's request for new terms is an application as defined by Regulation B, determine whether the lender's practices are consistent with the application and disclosure requirements of Regulation B. Refer to the ECOA examination procedures for additional information.
7. Determine whether the lender monitors or limits a borrower's usage of payday loans on an ongoing basis.
8. Determine whether the lender assesses income or other financial information to determine an applicant's ability to repay a loan without modifying or refinancing the loan.

Other Risks to Consumers

1. Determine whether payments are applied properly.
2. Determine whether the lender informs consumers in a clear and timely manner about fees, penalties, or other charges that have been imposed and the reasons for their imposition.

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; by assigning collection activity to third parties for a fee; or, by selling defaulted debts to a third party. The FDCPA does not apply to a lender collecting debts on its own behalf and under its own name. Practices that would otherwise violate the FDCPA, however, may be unfair, deceptive, or abusive.

Fair Debt Collection Practices Act

Assess compliance with the FDCPA when the lender is engaging in debt collection practices (e.g., they have purchased defaulted payday loans from another lender, or are using an assumed name). Refer to the FDCPA examination procedures for additional information.

Fair Credit Reporting Act

1. Note that, although lenders typically do not obtain a consumer report at the application stage, they may obtain a report for collection purposes. If a lender obtains a consumer report in the collection process, assess the lender's compliance with the FCRA. Refer to the FCRA examination procedures for additional information.
2. Lenders may choose to report information about a borrower to a consumer reporting agency. This may include providing information to a traditional credit bureau, but may also include providing information to another type of consumer reporting company (e.g., check verification firms). Reported information may include the number of outstanding loans, loan balances, and defaulted loan balances. Assess whether lenders maintain written policies and procedures regarding data accuracy, report information accurately, and have procedures in place to ensure that inquiries and complaints concerning reported data are appropriately resolved in accordance with FCRA requirements.
3. Assess compliance with the FCRA's furnisher requirements. Refer to the FCRA examination procedures for more information.

Other Risks to Consumers

1. Determine whether the lender contacts borrowers in an appropriate manner by assessing whether:
 - a. Employees and third-party contractors clearly disclose to consumers that they are contacting the consumer about the collection of a debt.
 - b. Employees and third-party contractors do not disclose the existence of a consumer's debt to members of the public without the consent of the consumer, except as permitted by law.

- c. The lender has policies on avoiding repeated telephone calls that abuse or harass any person at the number called.
2. Determine whether the lender makes misrepresentations or uses other deceptive means to collect debts. Determine whether the lender has appropriate controls to prevent such practices.

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. The lender's use of information in these contexts is subject to GLBA and its implementing regulations, which primarily cover the sharing of nonpublic personal information among third parties. 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 sharing practices with unaffiliated entities.

FCRA covers information sharing between affiliates (e.g., any company that controls, is controlled by, or is under common control with another company). Generally, although financial institutions may share customer transaction and experience information with affiliated entities, an affiliated entity may not use that information for marketing purposes unless the consumer is given notice and an opportunity to opt out and the consumer does not opt out.

Moreover, 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.

Gramm-Leach-Bliley Act and Fair Credit Reporting Act Requirements

1. Examiners should assess a lender's compliance with the GLBA examination procedures.
 - a. Determine whether the lender's information-sharing practices are consistent with the requirements of the GLBA.
 - b. Determine whether the lender accurately and timely discloses its sharing practices to consumers and customers. (For example, a person who applies for a payday loan is a consumer. A person who obtains a payday loan is a customer.)
 - c. Determine whether the lender properly manages opt-out requests.
2. Assess compliance with the FCRA's affiliate marketing rule. Refer to the FCRA examination procedures for more information.

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.

1. Evaluate whether the lender has compliance management controls for selecting and monitoring affiliates and/or third parties.

2. Evaluate whether the lender takes steps to ensure that the third parties it uses are licensed or registered to the extent required.
3. Evaluate whether the lender performs initial due diligence concerning the third party's prior regulatory compliance history before entering into an agreement (i.e., determining the existence and extent of any prior enforcement actions against the third party).
4. Evaluate whether the lender monitors the screening, hiring, and training practices of third-party employees who perform services on the lender's behalf.
5. Evaluate whether the lender takes steps to ensure third-party compliance with the lender's privacy policy with respect to data that the third party receives from or on behalf of the lender.
6. Evaluate whether the lender reviews the internal or external audit reports covering the third parties' activities and whether the lender responds appropriately to identified concerns.