Request for Information on Small Dollar Lending (RIN 3064-ZA04)

Submitted by mlongacre@csbs.org on Wed, 01/23/2019 - 09:21

Robert Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C., 20429

Re: Request for Information on Small Dollar Lending (RIN 3064-ZA04)

Dear Mr. Feldman,

The Conference of State Bank Supervisors ("CSBS") appreciates the opportunity to comment on the Request for Information issued by the Federal Deposit Insurance Corporation ("the FDIC") regarding small-dollar lending, and actions the FDIC can take to support the ability of banks to offer responsible, prudently underwritten small-dollar credit products to consumers. In the sections that follow, state regulators offer comments with a focus on several key themes:

- State legislatures govern the limits for acceptable features of small-dollar loans offered in their states. State regulators oppose any federal agency action that fails to respect the ability of states to control interest rates and impose additional consumer protections for small-dollar credit products.
- Any federal rulemaking must be coordinated with the Office of the Comptroller of the Currency ("OCC") and Consumer Financial Protection Bureau (the "Bureau" or "CFPB") to avoid creating a race to the bottom amongst federal regulators and an environment in which non-banks can attempt to circumvent state laws and regulations through contractual relationships with banks.
- Banks should be able to serve as a source of small-dollar lending in the communities they serve and more competition in the market at a lower cost could be positive for consumers.

The term “small-dollar lending” encompasses a wide variety of products offered by both bank and non-bank lenders that state regulators oversee. State regulators charter and supervise more than 78% of our nation’s banks and serve as the primary licensing authority and supervisor for companies in the non-bank consumer finance sector which includes payday lenders (in states that permit it), installment lenders, auto lenders, auto title lenders, and other consumer lenders. This regulatory responsibility is unique to state regulators, and it provides them with a unique view of the full range of credit products and services offered to consumers.

Small-dollar loan products are primarily governed by state law and differ significantly by rate, term, and various other factors. They exist on a spectrum that ranges from accommodation style lending that is not profit driven and primarily offered by community banks and credit unions as a service to existing customers, to traditional higher-cost payday style loans. Small- dollar loan products also include longer-term installment loans. The features of these loans and their affordability also differ widely based on the state where they are offered.

State regulators believe that to effectively regulate the market for small dollar loans, it is important to make clear distinctions between different types of loan products. Occasional small-loans made to known customers that are not part of a profit-generating loan program are completely different from profit-driven scalable high-cost loan programs.

As future rulemaking addressing small-dollar lending by banks is considered, federal regulators should respect the ability of states to control interest rates and the terms associated with lending products offered in their states. We believe it is possible to design a regulatory framework that would respect differences in state law.

The Bureau’s (soon to be re-proposed) 2017 Final Rule on Payday, Vehicle Title, and Certain High-Cost Installment Loans[1] (Final CFPB Rule) sets a federal floor for consumer protections for certain small-dollar loan products for the first time, while also allowing for states to enforce stricter laws where applicable. The Final CFPB Rule recognized the difference between accommodation loans and other small-dollar loans made as a primary line of business and provided threshold-based exemptions to preserve the ability of banks to offer this type of credit to consumers on a limited basis.[2]

Since the 1990’s the market for profit-driven consumer loan products has been dominated by payday and vehicle title lenders that offer loans at significantly shorter terms and higher rates than those traditionally offered by depository institutions. Despite strong ongoing demand for small-dollar credit, banks operating in the current

environment, for a variety of reasons, generally do not offer profit-driven small-dollar credit products at scale. Instead, small-dollar loans offered by banks are typically made as a service to existing borrowers in need of credit.

State regulators believe that a robust market for consumer lending depends upon viable market alternatives. Thus, it is critically important that banks, and especially community banks, be able to serve as a source of small-dollar credit in the communities they serve. For that reason, federal regulators should preserve the ability of community banks to offer small-dollar accommodation style loans to their customers, as the Bureau did in their Final CFPB Rule.

Given the sensitive interplay between state and federal regulation of consumer lending, we request an ongoing dialogue and consultation with the FDIC regarding rulemaking efforts in this area. We also request that any future rulemaking be coordinated with the CFPB and the OCC to avoid creating a race to the bottom between federal regulators or arbitrage opportunities between state-chartered banks, national banks, and non-banks offering small-dollar loans.

The sections that follow include detailed comments opposing preemption of state law, recommendations regarding the supervisory approach to consumer compliance examinations of community banks, a discussion of the Final CFPB Rule and recent guidance from the OCC, and recommendations regarding the path forward.

STATE REGULATORS OPPOSE FEDERAL AGENCY ACTIONS THAT WOULD ENABLE REGULATORY ARBITRAGE OR FAIL TO RESPECT STATE LAW

State regulators believe it is critically important that banks, and especially community banks, be able to serve as a source of small-dollar credit in the communities they serve. At the same time, however, State regulators also firmly believe that the right of states to control the types and terms of loan products permissible within their state is a critically important cornerstone of consumer credit protection.

In light of this commitment, our views on potential federal agency actions that could be taken to enable small-dollar lending are necessarily informed by the level of preemption afforded federally chartered, FDIC-insured banks by federal law. Given that banks are permitted to lend at the highest interest rate permissible for a lender under state law and given that banks are permitted to “export” permissible interest rates from one state to another, the legal obstacles to banks offering small-dollar loan products are few. Rather,

the primary impediments are reputational risks, profitability, and supervisory approach and expectations.

Since non-banks do not face these impediments to the same degree and have not been afforded the benefits of federal interest rate exportation or most-favored lender rules, the incentives for non-banks to attempt to garner these privileges through contractual arrangements are quite high. Courts have consistently applied the true lender doctrine under state usury and other consumer protection laws to hold that the "true lender" in these arrangements is the non-bank which negates the non-banks ability to take advantage of the preemption afforded banks.[3] In the face of this legal obstacle, non-banks have advocated for federal rules that would override the true lender doctrine. State regulators would oppose any attempt by federal regulators to preempt true lender doctrine applicable under state law.

To date, proposals to address the true lender issue have suggested the use of a highly formalistic test that would not look to the substance or facts of various business models, including the particular lending transactions, arrangements, operations or activities and thus, if adopted, would enable tremendous arbitrage of state law usury limits. No federal reform or federal regulator should attempt to preempt or ignore state laws relating to the true lender doctrine as any attempt to do so would significantly diminish the ability of states to control consumer credit and protect consumers in their states. Even if such a federal reform involved the appropriate federal banking agency applying a substantive, totality of the circumstances analysis to determine predominant economic interest (i.e. the type of analysis conducted by courts in true lender cases), the ability of states to control the terms of loan products within their state would still be significantly diminished. This is because federal regulators cannot be held accountable by state officials for how they interpret and apply the state laws enacted by state officials.

Federal agency action which ignores this structural impediment to accountability would nullify the ability of states and citizens of states to exercise control over consumer credit in their states. State regulators believe the wisdom in imbuing U.S. financial regulation in the U.S. with our federalist system of government is in enabling states "to respond, through the enactment of positive law, to the initiative of those who seek a voice in shaping the destiny of their own times without having to rely solely upon the political processes that control a remote central power."[4]

Nevertheless, as mentioned above, state regulators believe it is critically important that banks, and especially community banks, be able to serve as a source of small dollar credit in the communities they serve. We believe that there are actions the federal

agencies can jointly take that would accomplish this goal while respecting the essential role of states in consumer protection.

However, if the agencies cannot act jointly to achieve such a solution, state regulators would prefer simply preserving the Final CFPB Rule which set a floor for federal regulation without preempting the application and enforcement of stricter law by the states. Specifically, setting a federal floor for consumer protections in consumer lending allows states to act to address the needs of their citizens where gaps in the federal standard may exist or where it may otherwise prove to be ineffective.[5]

SUPERVISORY EXPECTATIONS REGARDING FAIR LENDING AND REGIONAL PRICING SHOULD BE CLARIFIED

Banks offering small dollar loans need to comply with a variety of federal consumer protection laws (TILA, ECOA, FCRA, EFTA, FDCPA, etc.) in addition to state specific laws and regulations.

Several banks have cited the fair lending examination process and lack of transparency regarding supervisory expectations as reasons for ceasing to offer small dollar loans.

One area in which there is uncertainty regarding federal regulators expectations is with respect to market pricing variances for consumer loan products. Federal regulators have communicated the expectation that pricing must remain consistent across products, and have noted that discretion within pricing for consumer loans is a key factor that elevates a bank's fair lending risk profile.[6] In practice, federal regulators have penalized banks for discretion in pricing even when loans are offered to customers in unique markets where customer characteristics differ significantly. Unfortunately, state regulators are aware of situations in which this supervisory approach has caused banks to reduce or exit their offering of small-dollar loan products.

State regulators encourage the FDIC to share its models for fair lending analysis of consumer loans, and to clarify supervisory expectations related to differences in regional pricing.

THE EXISTING REGULATORY FRAMEWORK: COMMENTS ON RECENT CFPB RULEMAKING AND OCC GUIDANCE RELATED TO SMALL DOLLAR LENDING

Even though the Final CFPB Rule allowed for high-cost installment loans, which are not legal or supported in a number of states, the Final CFPB Rule served as a federal floor and not a ceiling for regulation, leaving the door open for states to enforce their stricter laws.

The rule also protected the ability of banks to make limited amounts of accommodation style loans. Specifically, in response to comments from state regulators, the Bureau provided a carve out from the rule's coverage for banks that make less than 2,500 "accommodation" style loans per year. State regulators believe the inclusion of the de minimis exemption will protect the ability of banks to provide small-dollar credit to their customers. The late October announcement that the Bureau would re-evaluate the rule has caused uncertainty for both bank and non-bank lenders.

The October 2017 decision by the OCC to rescind their Deposit Advance Guidance and the May 2018 issuance of Core Principles for Short-Term, Small-Dollar Installment Lending ("Core Principles") has not brought clarity regarding how banks can offer small-dollar loans. It is clear from the language of the documents that the OCC expects banks to provide installment loans, as opposed to deposit advance-style products. However, the lack of coordination between federal regulators has left banks unsure of how new or existing small-dollar loan products will be evaluated by the various federal agencies that oversee them. Encouraging national banks to make longer-term installment loans that comply with the Bureau's rule does not reduce the uncertainty considering that a re-write of the Bureau's rule is expected in February. Given that the Bureau's next action is expected in February, it is concerning that the FDIC's comment deadline for this RFI is in late January.

While the Final CFPB Rule allowed for banks to make a limited amount of small-dollar loans, it generally disincentivized the offering of covered loans at scale given the complexity of the rule's compliance requirements. While state regulators have not reached a consensus regarding whether banks should offer covered small-dollar loans beyond the threshold provided for in the Bureau's di minimis exemption, we do feel that more competition in the market at a lower cost could be positive for consumers.

It is often noted that the inability to make a profit is an impediment to small-dollar lending by banks. However, many banks around the country have found sustainable ways to offer small- dollar loans to their customers. The majority of these loan products do not carry terms of less than 45 days, or balloon payment features, and thus would not be covered by the Bureau's rule. Outside of typical accommodation lending, banks have formed successful lending partnerships with CDFI's, non-profit organizations, and state and local governments. In addition, banks offer existing products that could be structured

as alternatives to more costly forms of short-term small-dollar credit.[7]

Despite the challenges associated with offering affordable and profitable small-dollar loan products, the majority of the banks that participated in the FDIC's Small-Dollar Loan Pilot from 2007 to 2009 concluded that they would continue to offer small-dollar loans beyond the pilot period.[8] In addition, the large volume of community banks who indicated they offer unsecured small-dollar consumer loans in the NCSB Survey suggest that many banks see an upside to offering these products. Even if the profit margin is slim, offering reasonable short-term credit can help to attract and retain customers, and could potentially have CRA benefits for a bank.

The FDIC's evaluation of existing programs and the provision of clear guidance to banks could increase awareness of potential avenues for small-dollar lending and clarify regulatory expectations.

GUIDANCE ON SMALL-DOLLAR LENDING SHOULD BE UPDATED AND EXPANDED

Banks would benefit from additional guidance regarding how they can profitably make small- dollar loans that meet both federal and state regulatory requirements and supervisory expectations. The FDIC's 2007 Guidance on Affordable Small-Dollar Lending and the template designed as part of the Small-Dollar Loan Pilot Program are good starting points that should be leveraged as the agency considers future rulemaking.

A functional cost analysis performed by federal regulators on small-dollar lending by banks could help to determine how banks can generate returns that are sufficient to cover operating costs and potential credit losses without imposing excessive costs on consumers.

The FDIC should also assess the findings of advocacy groups, including the Pew Charitable Trust[9] and the National Consumer Law Center[10], regarding how to structure responsible and profitable loans.

CONCLUSION

With clear and coordinated direction from federal regulators, State regulators believe it is possible for banks to provide competition within the market for small-dollar consumer loans, while also respecting state laws. Given the significant risks to consumer posed by usurious lending, federal regulators should, in consultation with states, coordinate on

future rulemaking efforts to ensure we do not create an uneven playing field for, or arbitrage opportunities between national banks, state banks, and non-banks.

Joint rulemaking could include reasonable limits on terms and features of scalable consumer loan products. For example, reasonable limits could be set on loan volume and gross revenue generated from a small-dollar loan product. Regulators should also provide clear expectations for underwriting and the assessment of a borrower's ability to repay. If coordinated rulemaking cannot be achieved, the agencies should allow the CFPB to set the floor for federal protections without preemption of stricter state laws.

To effectively regulate small-dollar loan products, federal regulators should make a clear distinction between profit-driven predatory loan products, and accommodation loans offered by many banks. Regulators should preserve the ability of community banks to provide accommodation type of credit in the communities they serve.

Ensuring that the supervisory process is transparent would also make it easier for banks to fill the demand for small-dollar loans and compete against non-banks that offer high-cost short- term credit products. To increase awareness of supervisory expectations, the FDIC should clarify expectations for pricing, and re-visit their 2007 Guidelines and exam procedures related to consumer lending.

An immediate step the FDIC could take would be to follow up with participants from the Small- Dollar Loan Pilot to assess the long-term profitability of the products offered during the pilot. State regulators share the Pilot's goal of determining how banks can profitably offer affordable and prudently underwritten small-dollar loan products as an alternative to high-cost credit payday loan products.

With the demand for small-dollar lending likely to continue, it is desirable for banks to be able to offer affordable and responsible small-dollar credit products. State regulators support their ability to do so in accordance with applicable state laws and consumer protection requirements. We look forward to engaging with the FDIC and federal banking agencies on this important topic. With appropriate regulation that covers both the bank and non-bank segments of the market for small-dollar consumer lending, we can ensure that consumers are protected and reduce the harms associated with high-cost usurious small-dollar lending products.

Sincerely,

John Ryan
President and CEO

1 Bureau of Consumer Financial Protection. 12 CFR Part 1041. [Docket No. CFPB-2016-0025] Final Rule: Payday, Vehicle Title, and Certain High-Cost Installment Loans

2 Accommodation loans would only be covered if they carry terms of less than 45 days or less and/or have balloon payment features. The 2017 final rule provided a carve out for accommodation style lending based on a loan volume threshold that was suggested by state regulators. The carve out was necessary because the short-term

3 See, e.g., CashCall, Inc. V. Morrisey, 2014 W. Va. LEXIS 587 (May 30, 2014). CashCall operated an internet loan program that used a South Dakota bank to fund consumer loans. CashCall was not licensed in WV and the loans to WV customer were in excess of the WV usury rate. State argued that CashCall was the true lender because it had the predominant economic interest in the loans. The Court ruled that the "predominant economic interest" test is the proper standard to determine the true lender because it examines the substance and not just the form of the bank/non-bank agreement.

4 See Gonzales v. Oregon, 546 U.S. 243, 126 S. Ct. 904, 163 L. Ed. 2d 748 (2006).

5 Testimony of Elizabeth Renuart, National Consumer Law Center. Public Hearing on the Financial Services Roundtable's Petition for Rulemaking to Preempt Certain State Laws. May 24th, 2005. Panel 4. Accessed here: https://www.fdic.gov/news/conferences/agency/public_may242005transcript_panel4.html

6 Federal Reserve Bank of Kansas City, FedConnections Consumer Affairs: Discretionary Credit Practices and its Effect on Fair Lending. August 28, 2018.

7 Reshaping the Future of Small-Dollar Lending in Texas: Alternatives to High-Cost Payday and Auto Title Loans. January 2012. Available here: https://www.texasappleseed.org/sites/default/files/15-PDL-Alternatives.pdf

8 FDIC Quarterly. A Template for Success: The FDIC's Small-Dollar Loan Pilot Program. 2010-Volume 4. Page 28

9 Standards Needed for Safe Small Installment Loans from Banks, Credit Unions. Pew. February 15, 2018. Available here: https://www.pewtrusts.org/en/research-and-analysis/issue-briefs/2018/02/standards-needed-for-safe- small-installment-loans-from-banks-credit-unions

10 Guidelines for Affordable Small Dollar Loans. National Consumer Law Center. January 2014. Available here: http://www.nclc.org/images/pdf/high_cost_small_loans/payday_loans/ib-affordable-small-

dollar-loans.pdf

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