Payday lenders - Great Banking Partners or Banking Liability?

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According to an article by nbcnews.com, “There are more payday lenders in the U.S. than McDonald's or Starbucks….”¹ As payday lenders grow in number, so do their critics. To many, the payday lending industry means over-priced and un-regulated loans; however, that is hardly the case. Often times, it is banking financial institutions (BFI) that have the biggest misconception of payday lenders, in thinking that they are predatory and take advantage of their customers. This mistaken belief can lead to banks considering payday lenders as a liability rather than a potential valued client.

Education based on objective data and factual analysis is the key for BFIs to understand the reasons why payday lenders make great banking partners and not banking liabilities, as is the pervasive belief. Before they make such determination, BFIs should strive to have accurate understandings as to what a payday loan actually is and, perhaps more importantly, what it is not. This paper will give BFIs a guide as to what constitutes reasonable controls while showing payday lenders ways to enhance controls that may already be in place.

So, what is a payday loan? The Consumer Financial Protection Bureau (CFPB) defines a payday loan or “cash advance” as a short-term loan, generally for $500 or less, that is typically due on the borrower's next payday.²

What is a payday loan?

Payday loans provide a small dollar, short-term loan to customers through an application and underwriting process. Payday loans are available to consumers for small unexpected expenses, and are not designed or intended to be a long-term financial solution. Most payday lenders require the customer to have the following:

- An open and active checking account,
- Proof of income, and
- Proper identification.

After successfully completing the application process, the consumer signs a loan agreement and receives his loan proceed funds, in cash or a company check. On the due date the customer may return to pay the amount owed, or the payday lender may either deposit the check or present the ACH authorization for the amount owed.

It is important to note that most states heavily regulate payday loans. Rules and regulations can greatly vary from state to state; however, they generally have the following features in common:

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¹ http://www.nbcnews.com/business/economy/there-are-more-payday-lenders-u-s-mcdonalds-n255156
² http://www.consumerfinance.gov/
- Small dollar amounts;
- Due date is usually on the day the customer is next scheduled to receive his or her income;
- The customer usually gives the lender a check or ACH authorization for the total amount due, but such check or ACH authorization will only be used in those cases where the customer fails to meet his or her repayment obligation under the agreement.

In addition to offering payday loans, most payday lenders also offer other ancillary financial services which may include the sale of prepaid debit cards, bill payment and wire transfer services (typically as an agent of another money services business [MSB]), and other short-term credit products.

### Who are payday lenders?

Many people struggle with knowing who payday lenders are, which is not surprising since the industry itself often struggles with the same question. Confusion often comes from knowing if a payday lender is a financial institution, an MSB, both or neither.

Payday lenders are often classified as non-banking financial institutions (NBFIs) or Non-Depository Financial Institutions (NDFIs). The reason for such designations is that payday lenders offer consumer financial services, but do not hold a banking license. These institutions are not allowed to take deposits from the public and are not regulated by a federal banking regulatory agency such as the Federal Deposit Insurance Corporation (FDIC) or the Office of the Comptroller of the Currency (OCC).

Are payday lender's considered MSBs by definition? According to the chart provided by The Financial Crimes Enforcement Network (FinCEN), businesses providing the

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<th>Product or Service</th>
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<td>Seller of Prepaid Access</td>
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product(s) and/or service(s) listed may be considered an MSB.

FinCEN states that if a business meets one or more of the definitions of a type of MSB, based upon the chart referenced, then the business is an MSB and must comply with applicable Bank Secrecy Act (BSA) requirements.³


In the ruling, FinCEN explains that in certain circumstances payday lenders are considered “check-cashers” therefore, they must comply with the regulations that are applicable to MSBs. The ruling referenced above explains that a payday lender who deposits or negotiates a check in an amount that exceeds $1,000 per person per day, is considered a check casher under the Bank Secrecy Act.

In summary, payday lenders are NBFIs that may also be classified as an MSB, depending on the other services offered by the payday lender and the circumstances under which such services are offered.

Risk Mitigation

Payday lenders acknowledge that there can be some risk associated with banking certain payday lenders. However, it is vital to remember that most payday lenders do everything possible to mitigate those risks.

Did you know that some payday lenders welcome sensible regulations to afford consumers protections from the bad actors in the industry?

The Community Financial Services Association (CFSA) is a national trade organization for short-term lenders offering small-dollar amount loans. The CFSA promotes the adoption of laws and regulations that are geared toward protecting consumer rights, while also preserving the industry ability to continue provide services to its customers by promoting “Best Practices” among the industry.⁴

³ http://www.fincen.gov/
⁴ http://cfsaa.com/
Payday lenders involved in this organization routinely exceed regulatory requirements and offer additional consumer-friendly protections to those provided by law. Some ways that payday lenders achieve these additional protections is by:

- Creating a risk assessment, and
- Establishing a Know Your Customer (KYC) Program

Risk Assessment

Regulations do not require payday lenders or MSBs to have a risk assessment program. So, why would payday lenders take the time and expense to establish one? Risk assessments provide a clear view as to the organization’s policies and procedures. The risk assessment identifies areas of high risk. These efforts allow the organization to establish a comprehensive Anti-Money Laundering (AML) Compliance Program that takes into consideration high-risk areas.

Know Your Customer (KYC)

“KYC” is a term with which banks are very familiar with, but how do payday lenders compare? While some payday lenders may not be familiar with KYC requirements, they are quite familiar with the concept of knowing your customer. Actually, even though payday lenders are not required to have formal KYC policies and procedures, such policies are nevertheless an area of focus in which they often perform well. The payday lending industry thrives on knowing their customer base and those customers’ needs. The most basic concept of KYC is customer identification, which can be handled in many different ways. But, are there other ways to “know your customer?” The list below includes policies that aide a payday lender in knowing its customers:

- Encourage employees to know what is normal for their customers;
- Ask customers about the purpose of the transaction;
- Have a clear understanding as to the products and services that the customer uses or may have a need for; or
- Ensure your customers are using the products and services for legitimate transactions.

By having a basic KYC program in place, organizations may be able to mitigate the risk of being used by criminals for money laundering activities. Such procedures will, in turn, mitigate the bank’s risk in having payday lenders as banking partners.
Consumer Compliance

Payday loans are highly regulated. Payday lenders must comply with a variety of laws and regulations including, but not limited to: state regulations, CFPB regulations, Regulation B, Regulation Z and Truth-in-Lending (TILA) Regulations.

State laws often govern aspects of the loan such as requiring centralized database(s) for consumer transaction monitoring, maximum fee caps, and minimum and maximum term length for the transactions.

As referenced above, payday lenders have a variety of federal laws and regulations with which they must comply. While state law typically regulates more of the actual transaction detail (such as the maximum amount that can be loaned to a customer), federal law regulates more of the overall loan process itself. Some specific areas that federal law oversees include disclosure requirements on the cost of credit, Collection Practices and Adverse Action Notices.

With so many state level requirements, in addition to federal law requirements for payday lenders, compliance can be a daunting task. So, how do payday lenders ensure compliance with state and federal laws?

Payday lenders often voluntarily implement systematic controls for compliance, thus allowing the organization to set certain rules that must be followed when processing a transaction. The controls are typically documented in corporate policies and procedures that may supplement the AML compliance program. They usually do not require board approval as they detail the day-to-day process for compliance. Controls implemented by the payday lender may be more restrictive than the rule or regulation mandating the payday lender’s operations. Such going “above and beyond” the legal requirements is due to CFSA members following the association’s best practices and understanding and serving their customers’ needs in a responsible and transparent manner. Often these controls are driven by the business need. For example, if the company’s average dollar amount for a loan is $300.00, the company may only offer a maximum loan amount of $300 even if state law allows for a $500.00 maximum loan amount.
AML Compliance Program

BSA requires certain payday lenders, which are MSBs, to comply with reporting and record keeping requirements. In addition to the requirements set forth for MSBs by FinCEN, payday lenders often adhere to best practices.

Regulations require MSBs to have an AML compliance program with the following basic requirements:

- **Designated Compliance Officer**
- **Written Policies and Procedures**
- **Continuous Training**
- **Independent Review**

Reporting Requirements

Basic reporting requirements under the BSA include:

- Currency transaction report (CTR)
- Suspicious activity report (SAR)
- Monetary instrument log

It is important to note that payday loans rarely have instances where these reports are necessary in connection with a loan transaction. For the most part, payday lenders would typically use these reports in instances where the payday lender is an agent of an MSB for products and services such as wire transfers, money orders sales, and/or prepaid cards.
The likelihood of using payday loans for money laundering is therefore extremely low, due to the following inherent characteristics of the product.

- Payday lenders are highly regulated and often have strong internal controls.
- SARs are required for transaction(s) that are deemed suspicious and meet a certain dollar threshold ($2,000).
- Payday lenders typically require government-issued ID, bank statements, Verification of Employment, as well as other underwriting criteria before conducting transactions subject to these regulations.
- Most payday loans are small-dollar amounts and are issued to the customer in the form of cash or a company check.
- Many states (Alabama, Delaware, Florida, Illinois, Indiana, Kentucky, Michigan, New Mexico, Oklahoma, South Carolina Virginia, Washington, and Wisconsin, to date) have centralized monitoring of a customer’s transactions through a database administrated by an unaffiliated third party.
  - State databases govern certain aspects of statutes and regulation to ensure both the lender and consumer are in compliance.
  - For example, a state database may monitor the number of loans a consumer has outstanding. These databases create another level of monitoring and customer identification verification.

CTRs are more prevalent among organizations that deal with high volumes of cash transactions. Although payday lenders may be deemed “check cashers” by FinCEN, locations rarely deal in large cash transactions.

Monetary instrument logs would only be used if the payday lenders are an agent of an MSB, wherein the report would be required. Typically, a payday lender would not need the form unless offering other products and services subject to the rules applicable to an MSB.

Payday lenders must analyze customer transactions to determine if a SAR, CTR, or monetary instrument log should be completed. For larger sized payday lenders simply relying on front-end employees for report filing is not adequate. A review of all transactions at set intervals is a highly effective way of detecting suspicious activity. The review of daily reports is necessary in determining the need for CTR and monetary instrument log reporting.

Record Retention

MSBs are required to maintain all relevant documentation for five years. These requirements include but are not limited to the following: policy and procedures, transaction receipts, and training documentation.
The Office of Foreign Assets Control (OFAC) of the U.S. Department of the Treasury (DoT) administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals. Payday lenders, like other financial institutions, must comply with OFAC compliance regulations. Payday lenders rarely if ever have a true positive OFAC match due to the low risk of payday lending being used by criminals for money laundering, terrorist financing, etc.

The low risk of payday lenders having a customer on the OFAC list is due to most payday lenders’ strong underwriting criteria that may include requiring the customer to have the following:

- Valid Social Security number (SSN)
- Government-issued ID
- Bank statements
- Verification of Employment

As a way to show enhanced compliance efforts, it is important for payday lenders to include OFAC compliance as part of their overall risk assessments.

Additional Oversight

What most people fail to understand about payday lenders is that the industry is hardly “unregulated.” In fact, it is among the most regulated financial industries in the country, being required to comply with numerous states’ regulations and statutes, with small differences that must be followed. Payday lenders have oversight from the following areas: federal regulators, state regulators, the IRS, CFPB, and FinCEN, just to name a few.

State Regulators

All states now regulate payday lending to some extent. As stated earlier, some states even go as far as requiring a centralized database. Not only does the database monitor a customer’s transactions, it also alerts the state regulator as to noncompliance of a payday lender.

Most state regulators also conduct regular examinations of the payday lender. These examinations ensure that the payday lender is maintaining compliance with state laws and regulations. State regulators often monitor for compliance with federal regulations.
IRS/BSA Title 31 Examinations

Once a payday lender is registered with FinCEN as an MSB, it opens itself up to examinations by the IRS. IRS examiners review the payday lenders compliance with applicable BSA/AML regulations. This review generally includes the following: AML compliance program, reporting requirements, record keeping and training documentation, among others.

CFPB

“With the establishment of the CFPB, a federal agency for the first time can supervise not only bank payday lenders but also all nonbank payday lenders...”

The CFPB oversees payday lenders in the following ways:

- Assessing the risk to consumers based upon the types of transactions conducted, volume of business, and state oversight;
- Coordinating oversight with state and federal agencies;
- Analyzing reports; and
- Conducting onsite examinations.

Summary

As bank partners receive enhanced due diligence from their regulators, payday lenders are often left under-banked or un-banked. By now, it should be clear why payday lenders are great banking partners and pose little risk to a BFI. Product characteristics indicate small-dollar loans, strong internal controls, and a myriad of federal and state regulatory oversight. Payday lenders often even impose stricter standards on themselves as industry best practices.

Payday lenders should take the following steps to reassure banks that they are a great banking partner:

- Create and keep a current AML and OFAC risk assessment
- Develop and maintain a risk-based AML compliance program
- Develop and maintain a strong risk-based KYC program
- Develop and maintain supplemental policy and procedures
- Implement a risk-based OFAC policy
- Create strong underwriting requirements
- Abide by industry best practices

It is vital for payday lenders to strive to meet all regulatory requirements as well as implement industry best practices thereby validating payday lenders as an asset with which banking institutions should be proud to partner.

Resources