WHITEPAPER

Proposed Guidance on Deposit Advance Products

BAI LEARNING & DEVELOPMENT

Introduction

On April 30, 2013, the FDIC proposed guidance on safe and sound banking practices and consumer protection in connection with deposit advance credit products.
The FDIC proposed supervisory guidance to clarify the agency's application of principles of safe and sound banking practices and consumer protection in connection with deposit advance products. The guidance details the principles that the FDIC expects their banks to follow in connection with any deposit advance product.

Synopsis of Guidance

The guidance is intended to ensure that banks are aware of what the FDIC views as significant risks associated with deposit advance products. The guidance also supplements the agency's existing guidance on payday loans and subprime lending.

Description: Deposit Advance Product

A deposit advance product is a type of small-dollar, short-term credit product offered to customers maintaining a deposit account, reloadable prepaid card, or similar deposit-related vehicle at a bank. The bank provides a credit feature that allows the customer to borrow in advance of the customer's next direct deposit. The advance is based on the customer's history of recurring deposits.

Typically, the advance is offered as an open-end line of credit. While the specific details of deposit advance products vary, the product generally incorporates some or all of the following items:

- **Cost –** The cost of the deposit advance is typically based on a fee structure, rather than an interest rate. Generally, advances are made in fixed dollar increments and a flat fee is assessed for each advance. For example, a customer may obtain advances in increments of $20 with a fee of $10 per every $100 advanced.

- **Eligibility, Loan Limits and Ability to Repay –** Typically, a customer is eligible for a deposit advance if the deposit account has been open for a period of time and the customer receives recurring direct deposits. Banks typically require a minimum sum to be directly deposited each month in order for the borrower to be eligible. The maximum dollar amount of the advance is typically limited to a percent or amount of the recurring monthly deposit. Some banks allow advances even if the customer is overdrawn, and some permit exceeding the credit limit from time to time.

  Typically, the bank does not analyze the customer's ability to repay the loan based on recurring debits or other indications of a need for residual income to pay other bills. The decision is based solely on the amount and frequency of their deposits.

- **Repayment –** Repayment is generally required through an electronic payment of the fee and the advance with the next direct deposit. The bank is generally paid first. If the first deposit is insufficient to repay the fee and the advance, the repayment is obtained from subsequent deposits. If the deposits are insufficient to repay the fee and the advance within a certain time period, then the bank executes a forced repayment by sweeping the underlying deposit account for the remaining balance. This may result in an overdraft, with overdraft fee(s) attached.

  Obviously, if the deposit is insufficient, financial difficulties are possible. Assuming the customer has no other source of income, the customer will need to rely on savings to pay bills until the next paycheck. Some banks have implemented alternative repayment methods that provide more flexibility to the customer, such as repayment by mail rather than electronically and installment options.

- **Repeat Usage Controls –** Banks often have repeat usage limits that trigger a ‘‘cooling off’’ period during which the customer cannot take out a deposit advance, or the credit limit is reduced. The time periods for these controls vary.

- **Marketing and Access –** Banks market deposit advance products as intended to assist customers through a financial emergency or to meet short-term needs. These advances, however, are typically not included with the bank’s list of available credit products, but are instead listed as a deposit account ‘‘feature.’’

Supervisory Concerns of Deposit Advance Loans

Although the FDIC encourages banks to respond to customers’ small-dollar credit needs, this guidance indicates that they are not “fans” of this product. The FDIC stated that these products share a number of characteristics seen in traditional payday loans, including high fees; very short, lump-sum repayment terms; and inadequate attention to the consumer’s ability to repay. The agency warns that banks need to be aware of the potential to harm consumers, as well as elevated safety and soundness, compliance, and consumer protection risks.

The FDIC is concerned that a bank’s customer could get caught up in a cycle of high-cost borrowing over an extended period of time. This is referred to as the ‘‘churning’’ of loans and is similar to the practice of ‘‘loan flipping’’ that the OCC, the FDIC and the Board have previously noted to be an element of predatory lending.

To avoid dependency on this product, some lenders now require borrowers who abuse the product to wait for a specified period before they are eligible to take out a new loan. However, the FDIC is concerned these ‘‘cooling-off’’ periods can be easily avoided and are ineffective in preventing repeated usage of these high-cost, short-term loans.

Safety and Soundness Risk

The FDIC has several safety and soundness concerns, discussed below:

- **Credit Risk –** Borrowers who obtain deposit advance loans may have cash flow difficulties or poor credit histories that limit other borrowing options. Failure to consider ability to repay and the borrower’s credit history presents safety and soundness risks.

  Numerous and repeated extensions of credit to the same individual may subject the bank to increased credit risk. While re-aging, extensions, deferrals, renewals, and rewrites of lending products can be used to help borrowers overcome temporary financial difficulties, repeated re-aging credit practices can cloud the true performance and delinquency status of the portfolio.

- **Reputation Risk –** Deposit advance products are receiving significant levels of negative news coverage and public scrutiny. Engaging in practices that are perceived to be unfair or detrimental to the customer can cause a bank to lose community support and business.

- **Legal Risk –** The significant risks associated with deposit advance lending products may subject institutions to the risk of litigation, both from private lawsuits and regulatory enforcement actions.

- **Third-Party Risk –** Banks remain responsible and liable for compliance with all applicable laws and regulations, even for the activities of a third party. The existence of third-party arrangements may, when not properly managed, significantly increase institutions' legal, operational and reputation risks.

  Other potential risks arise from or are heightened by the involvement of a third party, particularly if the third party will receive a portion of the fees. Consequently, third-party arrangements may expose the bank to regulatory action and affect the institution's ability to establish new or service existing customer relationships.

Compliance and Consumer Protection Related Concerns

Deposit advance products must comply with all applicable federal laws and regulations. State laws also may be applicable, including usury laws and laws on unfair or deceptive acts or practices. This whitepaper does not discuss in great detail many of the compliance regulations involved; however, it is worth noting that the first item in the "compliance list" provided by the FDIC is UDAP.

Federal laws and regulations applicable to deposit advance products include, but are not limited to, the following:

<u>The Federal Trade Commission Act (FTC Act) (UDAP)</u>
The FDIC enforces this section pursuant to its authority in Section 8 of the Federal Deposit Insurance Act. An act or practice is unfair where it: (1) Causes or is likely to cause substantial injury to consumers; (2) cannot be reasonably avoided by consumers; and (3) is not outweighed by countervailing benefits to consumers or to competition. Public policy may also be considered.

An act or practice is deceptive if: (1) There is a representation, omission, or practice that misleads or is likely to mislead a consumer; (2) the consumer's interpretation is reasonable under the circumstances; and (3) the misleading representation, omission, or practice is material.

Deposit advance products may raise issues under the FTC Act depending upon how the products are marketed and implemented. Any FTC Act analysis will be dependent on the facts and circumstances in a particular matter.

The prohibition on UDAP applies not only to the product, but to every stage and activity, from product development to the creation and rollout of marketing campaigns, and to servicing and collections. For example, marketing materials and disclosures should be clear, conspicuous, accurate and timely; and should fairly and adequately describe the terms, benefits, potential risks and material limitations of the product.

Truth in Lending Act (TILA)
TILA and Regulation Z require creditors to provide cost disclosures for extensions of consumer credit. Different rules apply to Regulation Z disclosures depending on whether the loan is an open- or closed-end credit product. Disclosures and advertising rules for open-end credit should be carefully considered.

Electronic Fund Transfer Act (EFTA)
A program that involves the use of electronic fund transfers must meet the applicable disclosure and other requirements of EFTA and Regulation E, including disclosures and limits on "mandatory EFTs."

Truth in Savings Act (TISA)
A program that involves a consumer's deposit account must meet the disclosure and advertising requirements of TISA and Regulation DD.

Equal Credit Opportunity Act (ECOA)
Any lending product always has the possibility of fair lending issues. Based on this product, those risks might be elevated.

Supervisory Expectations

Deposit advance lending presents significant consumer protection and safety and soundness concerns, irrespective of whether the products are issued by a bank directly or by third parties. The FDIC will take appropriate supervisory action to prevent harm to consumers, to address any unsafe or unsound banking practices associated with these products, and to ensure compliance with all applicable laws.

Examinations will focus on compliance and will assess credit quality, including underwriting and credit administration policies and practices. In addition, examiners will assess the adequacy of capital, reliance on fee income, and adequacy of the allowance for loan and lease losses. Management's oversight and relationships with third parties will also be assessed.

Credit Quality
The Uniform Retail Credit Classification and Account Management Policy (Retail Classification Policy) establishes guidelines for classifying consumer loans, such as deposit advance loans, based on delinquency, but also grants examiners the discretion to classify individual retail loans that exhibit signs of credit weakness, regardless of delinquency status.

Deposit advance loans often have weaknesses that may jeopardize the liquidation of the debt. Borrowers often have limited repayment capacity. Banks should adequately review repayment capacity, and review for evidence of ''churning'' and inadequate underwriting.

Underwriting and Credit Administration Policies and Practices
As part of the credit quality review, examiners will assess underwriting and administration policies and practices for deposit advance loan products. Eligibility and underwriting criteria for deposit advance loans, consistent with eligibility and underwriting criteria for other bank loans, should be well documented in the bank's policy. The criteria should be designed to assure that the extension of credit can be repaid according to its terms while allowing the borrower to continue to meet typical recurring and other necessary expenses such as food, housing, transportation and healthcare, as well as other outstanding debt obligations.

Repetitive deposit advance borrowings indicate weak underwriting and will be criticized in the Report of Examination and then taken into account in an institution's rating.

Bank policies regarding the underwriting of deposit advance loan products should be written and approved by the bank's board of directors, and consistent with the bank's general underwriting standards and risk appetite. Factors a bank should address include:

- **The Length of a Customer's Deposit Relationship with the Bank** – Banks should ensure that the customer relationship is of sufficient duration to provide the bank with adequate information regarding the customer's recurring deposits and expenses in order to prudently underwrite deposit advance loans. The FDIC guidance basically indicates a minimum of six months.

- **Classified Credits** – Customers with any delinquent or adversely classified credits should be ineligible.

- **Financial Capacity** – The bank should conduct an analysis of the customer's financial capacity including income levels. Underwriting assessments should consider the customer's ability to repay a loan without needing to borrow repeatedly from any source, including re-borrowing, to meet necessary expenses.

  The financial capacity assessment should include:

  - An analysis of the customer's account for recurring deposits (inflows) and checks/credit/customer withdrawals (outflows) over at least six consecutive months. Lines of credit of any sort, including overdrafts, and drafts from savings should not be considered inflows. In reviewing customers' transactions to determine deposit advance eligibility, the bank should consider the customers' net surplus or deficit at the end of each of the preceding six months, and not rely on a six-month transaction average.

  - After conducting the above described analysis, determine whether an installment repayment is more appropriate.

- **Cooling Off Period** – Each deposit advance loan should be repaid in full before the extension of a subsequent deposit advance loan, and banks should not offer more than one loan per monthly statement cycle. A cooling off period of at least one monthly statement cycle after the repayment of a deposit advance loan should be completed before another advance may be extended in order to avoid repeated use of the short-term product.

- **Increasing Deposit Advance Credit Limits –** The amount of credit available to a borrower should not be increased without a full underwriting reassessment in compliance with the bank's underwriting policies and in accordance with the factors discussed in this guidance. Any increase in the credit limit should not be automatic and should be initiated by a request from the borrower.

- **Ongoing Customer Eligibility** – As part of their underwriting for this product, banks should, no less than every six months, reevaluate the customer's eligibility and capacity for this product. Additionally, banks should identify risks that could negatively affect a customer's eligibility to receive additional deposit advances. For example:

- Repeated overdrafts (establish/set a certain number during a specified number of months).

- Evidence that the borrower is overextended with respect to total credit obligations.

Capital Adequacy
Higher capital requirements generally apply to loan portfolios that exhibit higher risk characteristics and are subject to less stringent loan underwriting requirements. Loans exhibiting subprime credit characteristics are higher risk loans and may require higher levels of capital.

Over-Reliance on Fee Income
Fees associated with deposit advance products should be based on safe and sound banking principles. Institutions should monitor for any undue reliance on the fees generated by such products for their revenue and earnings.

Adequacy of the Allowance for Loan and Lease Losses (ALLL)
Examiners will assess whether the ALLL is adequate to absorb estimated credit losses within the deposit advance loan portfolio. Examiners will also determine whether banks engaged in deposit advance lending have methodologies and analyses in place that demonstrate and document that the level of the ALLL is appropriate.

Consumer Compliance
Banks should implement effective compliance management systems, processes and procedures to appropriately mitigate risks. Examiners will review a bank's program with respect to deposit advance products for compliance with applicable consumer protection statutes and regulations.

Management Oversight
Examiners will assess bank management's ability to administer a deposit advance loan program and board oversight of the program. Furthermore, examiners will determine whether bank management has established controls and implemented a rigorous analytical process to identify, measure, monitor, and manage the risks associated with deposit advance loans. The bank's compliance management system should ensure continuing compliance with applicable federal and state laws, rules and regulations, as well as internal policies and procedures.

Banks should maintain adequate oversight of deposit advance programs and adequate quality control over those products and services to minimize exposure to potential significant financial loss, reputation damage, and supervisory action. Management should provide the appropriate oversight and allocate sufficient qualified staff to monitor deposit advance programs.

Results of oversight activities should be reported periodically to the financial institution's board of directors or designated committee, including identified weaknesses, which should be documented and promptly addressed.

Third-Party Relationships
Because third-party relationships are important in assessing a bank's overall risk profile, the FDIC's primary supervisory concern in reviewing a bank's relationships with third parties is whether the bank is assuming more risk than it can identify, monitor, and manage. Management should allocate sufficient qualified staff to monitor for significant third-party relationships, excessive usage by borrowers, and excessive risk taking by the bank. Therefore, examiners will review the risks associated with all material third-party relationships and activities together with other bank risks.

In certain high risk situations, examiners may conduct on-site third party reviews under specific authorities granted to the FDIC.

Responsible Products to Meet Small-Dollar Credit Needs

The FDIC recognizes the need for responsible small-dollar credit products among consumers. The FDIC's 2007 *Affordable Small-Dollar Loan Guidelines* (Guidelines) encourage insured institutions to offer small-dollar loan products that have affordable, reasonable interest rates with no or low fees and payments that reduce the principal balance of the loan. The Guidelines indicate that if structured properly, small-dollar loans can provide a safe and affordable means for borrowers to transition away from reliance on high-cost debt products.

This proposed guidance, and the rigorous requirements that are a part of the guidance, indicate that the FDIC is not convinced that these deposit advance programs are the appropriate answer. Those banks that currently have these programs should review them in detail based on this guidance – and those considering these programs should structure them carefully.
