

EXPERT ANALYSIS

Operation Choke Point: The CFPB Expands Its Oversight of Payday Lending

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The Consumer Financial Protection Bureau and other regulators' attempts to regulate payday lending have grown tremendously in the past year. In the most recent development, the U.S. District Court for the Eastern District of North Carolina on April 25 approved a civil settlement resolving an enforcement action against Four Oaks Bank & Trust Co., a small North Carolina bank.

The action stemmed from what the Department of Justice termed the "use of [Four Oaks'] accounts and its access to the national banking system in furtherance of a scheme to defraud consumers."¹

According to the DOJ's complaint, filed in January, Four Oaks entered into an agreement with a third-party payment processor that granted the processor direct access to the Federal Reserve Bank of Atlanta, which handles automated clearinghouse, or ACH, transactions.

Pursuant to the arrangement, the processor handled more than \$2.4 billion in transactions for its merchant customers. The vast majority of the transactions were for Internet payday lenders. Other transactions allegedly involved Internet gambling and a Ponzi fraud scheme.

"Payday loans" are unsecured consumer loans that must be paid off within a short period and the debts often carry high interest rates and fees. The CFPB says consumers, especially those who do not have access to other forms of credit, use these loans as a way to ease a cash-flow shortage between paychecks.

The DOJ further alleged that Four Oaks was aware of the fraudulent nature of many of its ACH transactions because it received a substantial number of requests from the borrowers' banks to verify the proper authorization of the transactions.

The DOJ also said the bank had high numbers of transaction reversals, called chargebacks, including a transaction return rate that was allegedly 21 times higher than the industry average.

The DOJ concluded that this arrangement violated the requirement, found in the Bank Secrecy Act and the USA Patriot Act, that Four Oaks have procedures in place to prevent it from providing national banking system access to entities engaged in unlawful activity.

According to the DOJ, without admitting to any wrongdoing, Four Oaks agreed to pay a civil penalty of \$1 million and to forfeit \$200,000 to the U.S. Postal Inspection Service's Consumer Fraud Fund as proceeds of the fraud alleged in the lawsuit.

In addition, the bank is required to assist the federal government in potential criminal investigations arising from the allegations, commission an independent review of its conduct and meet specific requirements before it can contract with any third-party processors in the future.

Specifically, Four Oaks cannot work with any processor that has, in the prior two years, serviced an Internet payday lender that has generated transactions in excess of specified return thresholds.

Further, Four Oaks must conduct due diligence to verify that any processor is not engaged in false or deceptive business practices.²

The Justice Department alleged that Four Oaks Bank & Trust Co., a small North Carolina bank, was aware of the fraudulent nature of many of its automated clearinghouse transactions.

The Four Oaks lawsuit is the first enforcement action in "Operation Choke Point," a joint action among the DOJ, the Federal Deposit Insurance Corp. and the CFPB to crack down on banks that facilitate allegedly abusive online businesses, including certain online payday lenders.

The DOJ issued subpoenas in spring 2013 to more than 50 banks and third-party payment processors in furtherance of the initiative. Additional civil enforcement actions are expected, though to date none have been announced.

Operation Choke Point has generated significant controversy. After the Four Oaks enforcement action was announced, Republican U.S. Reps. Darrell Issa of California and Jim Jordan of Ohio, chairs of the House Oversight and Government Reform Committee and the Economic Growth Subcommittee, respectively, sent a letter to Attorney General Eric Holder on Jan. 8 accusing the DOJ of abusing its power in Operation Choke Point.

In the letter, Issa and Jordan said "the extraordinary breadth of the department's dragnet prompts concerns that the true goal of Operation Choke Point is not to cut off actual fraudsters' access to the financial system, but rather to eliminate legal financial services to which the department objects."³

Issa and Jordan also requested that the DOJ provide records related to the initiative. According to news reports, a spokesman for the DOJ indicated that the department would respond to the letter.

Operation Choke Point is also part of a broader effort by the CFPB and other regulators to more closely control the payday lending industry. In a Nashville, Tenn., field hearing March 25, CFPB Director Richard Cordray announced the results of the bureau's yearlong study on payday lending.

According to the study, more than one in five initial payday loans (defined as the first payday loan to a consumer rather than the refinance or rollover of an existing loan) result in a sequence of seven or more renewal loans before the debt is repaid, leading to fees exceeding the amount initially borrowed.

The CFPB also found that about half of all payday loans are made to borrowers in sequences of loan renewals lasting 10 or more loans in a row. The study also focused on borrowers who receive income on a monthly basis, including elderly borrowers or disability recipients. Many of these borrowers remained in debt for the entire year of the study.⁴

The CFPB began its oversight of payday lenders in January 2012 and first formally accepted consumer complaints about payday loans in November 2013.

Also in November, the CFPB announced a consent order requiring Cash America, one of the country's largest payday lenders to refund up to \$14 million to consumers and to pay an extra \$5 million in fees for allegedly overcharging service members and their families in violation of the Military Lending Act.

As part of the investigation, Cash America dropped pending lawsuits, canceled judgments and corrected credit information related to nearly 14,000 collection suits filed in Ohio, which the CFPB contended were wrongful.

The CFPB then sued another short-term loan servicer, CashCall Inc., for what the agency alleged were unfair, deceptive and abusive practices. The CFPB said these practices including debiting consumer checking accounts for loans that carried interest rates that were illegal under applicable state law.⁵

At the March 25 field hearing, Cordray also announced that the CFPB was in the "late stages" of formulating new regulations for the industry. It is not yet clear what these regulations will be or how dramatically they will transform the industry.

Some industry watchers expect the new regulations to mirror proposed guidance issued by the Office of the Comptroller of the Currency and the FDIC for deposit advance loans. These guidelines require lenders to evaluate a borrower's ability to repay without having to roll the loan over, to reevaluate eligibility every six months and to include a condition that each such loan be repaid in full before a subsequent loan is made.

The guidelines also say there should be a cooling-off period between loans consisting of at least one monthly statement period.

As an indication of the dramatic effect these guidelines are likely to have on lenders providing deposit advances (and on payday lenders if the soon-to-be-issued regulations are similar), U.S. Bank stated in a comment letter that more than 90 percent of its deposit advance customers would be disqualified by the guidelines.

Once the proposed payday lending regulations are released, industry players and other interested parties will have time to review them and to comment and suggest revisions. The CFPB will then likely enact revised, final regulations that will take effect.

It is also expected that further enforcement actions and consent orders pursuant to Operation Choke Point will be announced.

Critics say the CFPB's goal both with Operation Choke Point and with the impending payday lending regulations is to destroy the payday lending industry as a whole. Cordray disputes this allegation.

"[W]e intend to make sure that consumers who can afford to take out small-dollar loans can get the credit they need without jeopardizing or undermining their financial futures," he said at the Nashville field hearing. "But we also need to recognize that loan products which routinely lead consumers into debt traps should have no place in their lives."⁶

After the successful resolution of the Four Oaks matter, it appears that Operation Choke Point is here to stay. Industry watchers expect efforts by the CFPB and DOJ to crack down on lax oversight of third-party payment processors and payday lending in general to increase both in reach and in intensity.

NOTES

¹ See *United States v. Four Oaks FinCorp Inc. et al.*, No. 14-CV-00014, *complaint filed* (E.D.N.C. Jan. 8, 2014).

² See U.S. Dep't of Justice, *Holding Accountable Financial Institutions that Knowingly Participate in Consumer Fraud*, JUSTICE BLOG (May 7, 2014), <http://blogs.justice.gov/main/archives/3651>.

³ See Letter from U.S. Reps. Darrell Issa and Jim Jordan to U.S. Attorney Gen. Eric Holder Jan. 8, 2014), *available at* <http://bit.ly/1hgAToE>.

⁴ CONSUMER FIN. PROT. BUREAU, CFPB DATA POINT: PAYDAY LENDING (March 2014), *available at* <http://1.usa.gov/ShErLs>.

⁵ *Consumer Fin. Prot. Bureau v. CashCall Inc. et al.*, No. 1:13-cv-13167, *complaint filed* (D. Mass. Dec. 16, 2013), *available at* <http://1.usa.gov/1k7rsqH>.

⁶ Richard Cordray, Director, Consumer Fin. Prot. Bureau, Remarks at the Payday Field Hearing (Mar. 25, 2014), *transcript available at* <http://1.usa.gov/1nxbREj>.

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