Office of Thrift Supervision
Department of the Treasury

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MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Richard M. Riccobono

SUBJECT: Title Loan Programs

Summary

The Office of Thrift Supervision (OTS) has learned that vehicle title loan companies are approaching depository institutions urging them to enter into a contractual arrangement to fund title loans. OTS has a variety of safety and soundness, compliance, and consumer protection concerns regarding title lending programs. OTS will closely review the activities of savings associations engaged in this type of lending and initiate corrective measures, including enforcement actions where appropriate, when the institution is not following prudent lending practices or when examiners consider the savings association's lending practices to be abusive.

Background

A title loan is a short-term consumer loan made to an individual secured by clear title to the borrower's vehicle. Title loans are generally made for a term of 30 days at high interest rates (sometimes as high as 25% or more per month, equal to 300% or more annually). The typical title loan arrangement allows a borrower to extend the loan several times by paying the interest due for the previous month. When a borrower is unable to pay the previous month's interest, it is rolled over into the loan, thus increasing the amount owed and putting the borrower deeper in debt. Ultimately, if the borrower cannot pay the progressively steeper payments, the lender takes possession of the vehicle and sells it. If the vehicle is sold for more than the loan amount, the lender typically does not refund the excess to the borrower.

Title companies are pursuing depository institutions to participate in these ventures in order to avoid usury laws in states where lending at such high interest rates is prohibited. Participating depository institutions are promised high income with minimal initial investment. Although they may have appeal, funding arrangements with title loan companies could threaten both the financial stability and the reputation of an association. Title lenders that seek to affiliate with federal thrifts should not assume that the benefits of a federal charter, particularly in relation to state and local law, will be available.

Significant Risks

Title loan programs involve several lending practices that may be abusive, specifically:

- Interest rates and fees are inordinately high;
- Loan terms make it difficult for the borrower to repay the loan as agreed; and
- Title loan programs generally target individuals who are less financially sophisticated or are otherwise vulnerable to abusive lending practices.

In addition, title lending carries significant counterparty, credit, operational, reputation, and compliance or legal risks that raise several supervisory concerns. These risks are discussed below.

Credit Risk - Title loans are generally made to borrowers with limited financial capacity and often blemished credit histories. These loans are often considered subprime and entail considerable credit risks that must be controlled by institution management, as discussed in the Interagency Guidance on Subprime Lending (March 1, 1999).

Prudent lending standards require an institution to determine the borrower's financial capacity, the value of the collateral pledged, and the condition and location of the collateral. Title loans are often made based on the value of the collateral alone rather than the borrower's willingness and ability to repay the loan. OTS generally considers lending to individuals who are not able to service their loans, and based solely on the value of the collateral pledged, to be an unsafe and unsound lending practice. When a borrower does not have the ability to service the loan from sources other than the collateral pledged, it will be classified Substandard, and may be placed on non-accrual status.

Title loans that remain on the institution's books are subject to the Uniform Retail Credit Classification and Account Management Policy, which establishes parameters for the number of times a past due loan may be refinanced, extended or renewed. The policy states that an institution must establish standards for such renewals based on the borrower's willingness and ability to repay the loan, and that the institution should also establish standards for the number of renewals that can be made on a loan in a given time period. Since title loans are often made for a 30-day term, are typically renewed four to five times, and are based on the value of the collateral and not the borrower's ability to repay, such renewals are not likely to meet the requirements of that policy.

The institution must have controls in place to ensure that policy guidelines governing title loans are adequate and prudently followed. In addition, the institution should establish reasonable and prudent concentration limits for its title lending activities. Moreover, when an institution purchases title loans, such arrangements may be subject to the lending

limitations of 12 C.F.R. 560.93. For example, if the loans are sold with recourse or guaranteed they may be subject to the loans-to-one-borrower limits.

Finally, institutions must maintain additional capital and allowances for loan and lease losses (ALLL) commensurate with the added credit and other risks associated with their title lending activities. The level of additional capital and ALLL required for these loans, which are typically of subprime quality, will depend on the level of such activity, the quality of the underwriting, controls, staffing over the institution's title lending activities, and the quality and the performance of the institution's title loan portfolio.

Counterparty Risk - Savings associations that enter into a contractual agreement with a third party, such as a title loan company, expose themselves to counterparty risk. Counterparty risk is the risk that a third party may become unwilling or unable to meet the terms of a contract.

In some arrangements, the title loans may be referred to the institution solely for origination, and then sold immediately to the title company. If the title company fails to fulfill its obligation to purchase these loans, the institution would be exposed to further credit risk. In other arrangements, the thrift might be required to fund some or all of the loans. In this case, the savings association's credit exposure must be identified, measured, monitored, and controlled.

When an institution establishes such an agreement with an independent agent, management must perform a due diligence analysis of the agent to determine its creditworthiness, reputation, and ability to meet the terms of the agreement. The thrift must also establish prudent policies within the agreement itself. The agreement must establish adequate controls over the transactions and should clearly delineate terms of the agreement. If the counterparty originates loans as an agent of the thrift, the agreement should include underwriting and servicing standards, funding procedures, reporting requirements, compensation, and other terms. In addition, institutions must ensure that the terms of the agreement provide for adequate safeguards, controls and appropriate disclosures, including Truth-in-Lending disclosures. Similarly, if the title company contracts to purchase the loans originated by the thrift, the agreement should specify the terms and timing of such purchases. Regardless of the services provided, the institution should also obtain authorization, in the agreement, for an audit or examination of the third party by OTS.

Operational Risk - Title loans are a form of specialized lending not typically found in savings associations. Title loans can be subject to high levels of transaction risk given the large volume of loans, the handling of credit and collateral documents, and the movement of loans and funds between the savings association and third-party originators or purchasers. Because title loans may be underwritten off-site, there is the risk that agents or employees may misrepresent information about the loans or fail to adhere to established underwriting guidelines. Internal controls must be in place to ensure that policy guidelines governing title loans are followed. The internal audit program should address the level of risk, and set an adequate scope to ensure that controls at the savings association and the title lender are adequate and prudently followed. Information systems supplied by third parties also need to be reviewed and audited to ensure accurate recordkeeping and system integrity. The institution should implement controls to mitigate fraud, including periodic audits and account confirmations.

Reputation Risk - The overwhelming majority of federally insured institutions have exhibited a long-standing history of avoiding questionable activities that could tarnish their reputations. Title loans raise significant consumer protection concerns because of their high costs. Due to the high fees associated with title lending, many observers view them as abusive. OTS has other significant consumer protection concerns when collection practices permit the lender to take possession of the collateral without providing the borrower with the opportunity to cure the default or share in the net proceeds of the sale of the collateral. Lawsuits or public enforcement actions about an institution's direct lending practices, or indirect funding of such practices, could cause a lender to lose much of its hard earned and long-standing community support and business.

Compliance and Legal Risk - Title loans are subject to federal and state consumer protection and fair lending laws. Institutions that originate or purchase title loans must take special care to ensure compliance with the relevant provisions of the Equal Credit Opportunity Act, the Truth in Lending Act (TILA), the Fair Credit Reporting Act, the Fair Debt Collection Practices Act, and the Federal Trade Commission Act, as well as applicable provisions of state usury and deceptive practices acts. Title lending could be subject to class action lawsuits and litigation stemming from alleged violations of these consumer protection statutes or common law.

Insured depository institutions are responsible for the loan products they sponsor and the distribution channels they employ. Management needs to ensure that the delivery of loans does not reflect a pattern of discrimination or the targeted exploitation of unsophisticated borrowers. OTS will hold institutions accountable for the activities of others acting on behalf of the thrift in its title loan operations. Therefore, an adequate compliance management program must be established to identify, monitor and control the consumer protection risks associated with the institution's title lending programs at all points in the distribution process. Such a program needs to recognize applicable state as

well as federal consumer regulations. For instance, title loans raise questions as to the lender's compliance with applicable state consumer and usury laws in connection with perfecting a valid security interest in the collateral pledged.

Finally, institutions should develop a process to monitor, analyze and ensure appropriate resolution of consumer complaints concerning title loans, whether received at the institution or by third parties participating in title loan transactions.

New Title Lending Arrangements

Institutions should consult with their Regional Office prior to engaging in title lending activities. In addition, institutions are reminded that, before engaging in title lending activities through a subsidiary, prior notification is required under 12 CFR 559.11. Furthermore, OTS has determined that such activities constitute a significant issue of policy and thus are not eligible for processing under delegated authority by the regional director. In its review of any such notice, OTS will take into account the significant risks associated with title lending activities and arrangements with third parties described in this memorandum. OTS will also consider how the thrift will address and otherwise mitigate these risks consistent with these guidelines.

Supervisory Concerns

Because of the risks involved, savings associations engaged in title lending, directly or indirectly, will be subject to additional oversight. As part of the examination process, OTS will closely examine any lending or financing arrangements savings associations have with title loan companies. Depending on the nature of any such arrangement, OTS may conduct examinations of the title loan companies.[1] Such examinations may result in OTS assessing the savings association additional fees under 12 CFR 502.60(e) for the additional costs to conduct an examination of a title lender that provides third-party services to an institution. Furthermore, OTS will bring enforcement actions to correct violations of law and regulations by the savings association or a title company.

Conclusion

Institutions that are approached by a title loan company seeking to enter into a funding arrangement are cautioned to carefully consider the possible ramifications of such a venture. Management should consult not only legal counsel, but also the local OTS Regional Office before committing to participate in funding vehicle title loans.

[1] OTS will treat arrangements in which title loan companies provide services in connection with the origination, servicing, and collection of title loans on behalf of savings associations as subject to the provisions granted by the Examination Parity and Year 2000 Readiness for Financial Institutions Act (Pub. L. No. 106-164 enacted March 20, 1998, 12 U.S.C. 1464(d)(7)(D)). Therefore, the performance of the third party in connection with the arrangement will be subject to examination by OTS to the same extent as if the institution itself was performing such services. This does not, however, include examination of activities of a provider that do not involve the savings association or the general financial and legal condition of the third party provider.