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Report to the Chairman, Subcommittee on Financial Institutions and Regulatory Relief, Committee on Banking, Housing, and Urban Affairs, U.S. Senate

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LIVE LOAN CHECKS

Information on Unsolicited Consumer Loans for Preapproved Borrowers

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The Honorable Lauch Faircloth
Chairman, Subcommittee on Financial
Institutions and Regulatory Relief
Committee on Banking, Housing, and Urban Affairs
United States Senate

Dear Mr. Chairman:

This report responds to your request that we provide information on live loan checks. Live loan checks are preapproved loans extended to potential borrowers by sending them unsolicited, negotiable checks. When recipients sign, then subsequently cash or deposit the checks, they obtain the loans. Lenders preapprove recipients for these live loan checks after assessing their creditworthiness.

As agreed with your office, this report provides available information concerning (1) the characteristics of live loan checks and the major organizations that provide unsolicited loan checks; (2) the volume of live loan checks in 1995, 1996, and 1997 and the expected volume in 1998; and (3) the benefits and risks of live loan checks for the borrowers and lenders. We also agreed to provide available information on losses associated with live loan checks.

To compile this information, we interviewed officials representing federal regulatory agencies, one banking association, one rating agency, one consumer advocacy group, and three lending institutions (lenders) offering live loan checks. We also reviewed publicly available information, including published reports on live loan check issues and industry standards for live loan checks. Limited information exists on live loan check volume and losses industry-wide, and we relied primarily on specific lending institution data. While we did not independently verify these data, we corroborated evidence with other independent sources whenever possible. We conducted our work between January and June 1998.

Results in Brief

Once cashed, live loan checks result in unsecured consumer loans.[1] Bank officials we interviewed told us that live loan checks are aimed at the most creditworthy customers—that is, those least likely to be delinquent or in default in making loan payments. According to Fleet Bank (Fleet) and

[1]Unsecured loans are not backed by collateral.

Chase Manhattan (Chase) officials, such loans are made at interest rates ranging from 12.9 percent to 15.9 percent, compared to an average 16 percent for credit cards.[2] Fleet officials told us that it has sent potential borrowers live loan checks ranging from $3,000 to $10,000 based on its estimate of the borrower's ability to repay the loan. The repayment terms for these loans ranged from 48 months to 60 months, and the loans were amortized.[3] Fleet officials stated that borrowers generally have used the loan amounts for expenses such as home improvements, debt consolidation, and school expenses.

According to bank officials we interviewed, at least eight financial institutions have offered live loan checks. Of these eight financial institutions, six were banks: Chase, Fleet, First USA Bank, Signet Bank,[4] BancOne Corporation, and First Chicago NBD. Two were nonbanks:[5] Capital One and Beneficial Corporation. First Chicago stopped offering these loans after suffering a level of losses that it considered "not acceptable" during a pilot program.

Public and private sector officials told us that comprehensive data on the volume of live loan checks were not available and that no one was tracking volume data. One institution—Fleet—provided us with quantitative data on its live loan check program. Between 1995 and 1997, Fleet mailed 4.35 million live loan checks. Of these, approximately 155,000 borrowers cashed the checks and accepted the loans. Fleet made over $680 million in loans through this program. Fleet officials told us that it experienced 68 confirmed cases of fraud, which generally involved someone other than the intended recipient cashing the check.

Public and private sector officials identified benefits and risks associated with live loan checks for both borrower and lenders. In the views of these officials, borrowers benefit from live loan checks because these checks meet their needs for immediate access to funds at interest rates competitive with those offered by credit cards. Risks to the borrowers

[2]According to the Federal Reserve, as of May 7, 1998, this was the average interest rate charged by commercial banks for credit cards.

[3]Amortization is the reduction of a debt by periodic payments of interest and principal on an unpaid loan balance for the life of the loan.

[4]On March 20, 1998, First Union Corporation purchased Signet Bank.

[5]The U.S. Congress defines a commercial bank as an institution that (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans. This statutory definition is important because, by not engaging in either of these special activities, a corporation can own and operate an institution that otherwise operates like a bank, without being subject to Federal Reserve regulation as a bank holding company. Financial institutions that fit this mold have been referred to as nonbanks.

include the potential for these loans to compound problems associated with high levels of consumer borrowing. In fraud situations, losses are to be absorbed by the bank and/or the institution honoring the check, rather than by the borrower. A consumer advocacy group official noted, however, that the potential borrower may face considerable inconvenience in correcting personal credit records after a forged endorsement occurs.

Two lenders—Fleet and Chase—informed us that, while loans initiated from cashing live loan checks were a small percentage of their bank assets, the programs thus far have been profitable, with manageable risks. They said that losses were managed by targeting the loans to the most creditworthy borrowers. However, one lender—First Chicago—discontinued offering these loans after suffering losses during a pilot program.

Background

According to the American Financial Services Association (AFSA),[6] some of its members have been issuing live loan checks since the 1980s. Live loan checks are delivered in the mail and are preapproved offers of credit. Consumers are selected to receive the loan offers if they meet certain credit criteria.

These preapproved offers of credit are based, in part, on a consumer's credit score. Credit bureaus develop scores by assessing various types of information collected from a large pool of borrowers, including borrowers with good payment histories and others with poor payment histories, to estimate the credit risk[7] associated with different types of loans. Credit scoring systems use statistical analysis to identify and weigh the characteristics of borrowers who have been most likely to make loan payments. For example, borrowers with little or no history of delinquent payments receive higher credit scores than borrowers with many delinquent payments. Most widely used credit scoring systems have a range of scores from 350 to 900. Borrowers with higher scores are considered more creditworthy because they are more likely to repay the loan on time and in full than are borrowers with lower credit scores.[8]

[6]Founded in 1916, AFSA is a trade association for a wide variety of market-funded providers of financial services to consumers and small businesses.

[7]Credit risk is the risk that an obligation will not be paid on a timely basis.

[8]Even though borrowers with higher scores could become delinquent or default and some borrowers with lower scores could pay the loan as required, statistics show that borrowers with higher scores are more likely to pay the loan on time, and in full, than are borrowers with lower scores.

Live Loan Checks Have Certain Characteristics

While comprehensive data on live loan checks are not available, data provided by one lender depict its loans as amortizing loans with interest rates below credit card rates. According to this lender, the recipients of its live loan checks had high credit scores and good credit histories. Chase and Fleet officials provided us with the materials they sent to the recipients of live loan checks. The materials include information disclosing that the check represents a loan and presenting the terms and conditions of the loan. Voluntary industry standards also call for such disclosure.

Average Live Loan Check Profile

Comprehensive industry data on the average live loan check and the borrower using this product are not available. Fleet and Chase officials, however, provided us with information on their live loan check profile. According to Fleet, borrowers receive live loan checks ranging from $3,000 to $10,000, based on the lender's estimate of the recipient's predicted ability to repay the loan. Prior to selection, recipients had demonstrated their ability to manage debt by having satisfactory payment histories. According to Fleet and Chase officials, interest rates on loans resulting from live loan checks have ranged from 12.9 percent to 15.9 percent. The repayment terms for these loans ranged from 48 months to 60 months and are amortized. In addition, Fleet's live loan checks generally were only valid for 6 weeks from the date of issuance;[9] this provision is intended to lessen the risk of using outdated credit data as a basis for assessing a potential borrower's creditworthiness.

Average Live Loan Check Borrower's Profile

Borrowers' credit scores were used as the primary factor in determining whether to offer a live loan check, and credit criteria were conservative in the lender's view. Fleet officials told us that their borrowers had an average credit score of 730, with a minimum cut-off of 690. A credit score of 730, for example, implies odds of 125 to 1 against defaulting on an unsecured loan—that is, the estimated probability of default is less than 1 percent. The officials said that Fleet borrowers primarily resided within the established franchise area where the bank offers retail banking services.[10] The borrower had a median household income of $44,000.[11] In addition to having to meet a minimum credit score, borrowers also were to

[9]According to industry standards, live loan checks can be valid for 6 months.

[10]Fleet's franchise area comprises Maine, Connecticut, Rhode Island, Massachusetts, New York, New Jersey, and New Hampshire.

[11]According to Census Bureau data, the median household income in the northeastern region of the United States was $39,368 in 1996.

meet minimum requirements set by proprietary risk and bankruptcy models,[12] according to Fleet officials. The borrower's average debt utilization—that is, the proportion of available credit limits actually used in unsecured debt on current revolving credit sources—was 29 percent, which the bank believes estimates the borrower's propensity to use credit. Also, borrowers had no prior record of bankruptcy, foreclosure, tax liens, or garnishments.[13] According to AFSA, its members who offer live loan check programs reported that borrowers extended live loan check offers are generally between 35 and 50 years of age with income levels between $35,000 and $55,000.[14]

Disclosure Was Made to Borrowers of Live Loan Checks

Interviews with lenders, bank regulators, and the Federal Trade Commission (FTC), which is responsible for, among other things, fostering free and fair business competition and preventing monopolies and activities in restraint of trade, revealed few complaints that live loan checks terms were not disclosed to borrowers. According to lenders, disclosure requirements are intended to protect the borrower and the lender. Office of the Comptroller of the Currency (OCC) officials consider live loan checks to be like any other small consumer loans in needing to meet Truth In Lending Act[15] requirements ensuring that creditors disclose credit terms and the cost of credit as an annual percentage rate (APR).

We spoke with lenders about the disclosure features of their live loan check programs. Fleet and Chase officials provided us with copies of their disclosure materials, which contained information that identified the loan check as a loan and clearly specified the interest rate and the terms and conditions of the loan. In the lenders' solicitation materials, for example, there were several statements such as, "this is a check for a loan" or "loan check." The interest rate, repayment terms, and other terms were displayed. The live loan checks were labeled "non-transferable" and "for deposit only" to help ensure that the customers would take the checks directly to their own banks for deposit. Chase officials told us that, under their policy, a customer is to be called by a Chase bank official when the check is presented by the depository bank to Chase for payment, to ensure that the intended person actually deposited the check.

[12]These models were developed to predict bankruptcy and to further reduce the bank's risk.

[13]A garnishment is a court order to an employer to withhold all or part of an employee's wages and then send the money to the court or to a person who won a lawsuit against the employee.

[14]According to Census Bureau data, the median household income nationally was $35,492 in 1996.

[15]The Truth in Lending Act, 15 U.S.C. 1601 et seq. The act is implemented by the Federal Reserve Board's Regulation Z, 12 CFR part 226.

The Industry Has Developed Voluntary Standards for Live Loan Checks

AFSA issued voluntary standards for live loan checks on September 17, 1997, and expanded them on October 29, 1997. According to an AFSA official, the voluntary standards for live loan checks are intended to provide extra protection for consumers. Bank officials told us that they abide by the voluntary standards to avoid the risk of creating a negative image of the live loan check program. AFSA voluntary standards are as follows:

- Live loan checks sent by mail or other similar instruments offered by AFSA members are to be negotiable up to 6 months after receipt. A lender's printed material accompanying the offer must advise the consumer to void and destroy the instrument if it is not going to be negotiated.
- Live loan checks sent by mail must include the following disclosure: "This is a solicitation for a loan—read the enclosed disclosures before signing and cashing this check."
- Solicitations are to be mailed in envelopes with no indication that a negotiable instrument is inside. Envelopes are to be marked with instructions informing the Postal Service not to forward the item if the intended recipient is no longer at the address on the envelope.
- In the event a live loan check-by-mail offer is stolen or fraudulently cashed, the intended recipient is to have no liability for the loan obligation.
- In order to deter theft or forgery, a consumer is to be asked to complete a confirmation statement provided by the creditor.

Major Participants Offering Live Loan Check Programs

Public and private sector officials told us that, while there was no comprehensive list of institutions with live loan check programs, several institutions were known to have offered such programs. Banks included Fleet in Boston, Massachusetts; Chase Manhattan Bank in New York, New York; Signet Bank in Richmond, Virginia; First USA in Wilmington, Delaware; and BancOne Corporation in Columbus, Ohio.[16] Nonbanks included Capital One in Falls Church, Virginia, and Beneficial Corporation in Wilmington, Delaware.[17] First Chicago NBD had conducted test marketing of live loan checks; a First Chicago official told us that the bank discontinued the program because the level of loss in a pilot program was not acceptable.

[16]On April 13, 1998, BancOne and First Chicago NBD announced a merger that is expected to be completed during the fourth quarter of 1998. The new headquarters will be in Chicago.

[17]On April 7, 1998, Household International and Beneficial Corporation announced a merger agreement that is expected to be completed in the third quarter of 1998.

Regulators and industry officials we interviewed also told us that no comprehensive data show the volume of live loan check activity. These officials also believed that it would be difficult for nonregulators to compile such industrywide information because individual financial institutions might be reluctant to release their proprietary data.

Although comprehensive industry data were not available, Fleet officials provided us with information on Fleet's live loan check program history. (See table 1.)

Table 1: Fleet's Live Loan Check Program History Showing the Volume of Live Loan Check Activity for the Period 1995 Through March 1998

Year	Number of live loan checks mailed	Percent of solicited potential borrowers who were Fleet customers	Number of loan acceptances	Loan amount (millions of dollars)[a]
1995[b]	50,000	100	8,000	$30
1996[c]	2,100,000	60	94,000	$400
1997	2,200,000	25	53,000	$250
1998 (through March)	1,500,000	8	N/A	N/A
Total	**5,850,000**		**155,000**	**$680**

Legend:

N/A = not available.

[a]These figures are estimates.

[b]Nineteen ninety-five was a test year.

[c]In 1996, most of the live loan checks were sent to Fleet customers. The 40 percent sent to non-Fleet customers were in the New England area, where Fleet officials said that consumers could recognize Fleet's name.

Source: Fleet Bank.

Although a similar number of checks were mailed in 1997 as in 1996, Fleet experienced far fewer acceptances in 1997 compared with 1996. Fleet officials said that the decline in acceptances occurred because in 1997 the potential borrowers were primarily non-Fleet customers, who were less likely to recognize Fleet's name.

Benefits and Risks Are Associated With Live Loan Checks for Both Borrowers and Lenders

Public and private sector officials identified some benefits and risks associated with live loan checks for both borrowers and lenders. In general, the benefit for borrowers was the ease of obtaining the loan; the risks to a borrower were comparable to those for other unsecured loans. The Consumer Federation of America (CFA) told us that these loans could compound problems caused by high consumer debt. For lenders, the loans were often seen as profitable, with manageable risks. However, limited data exist on the losses associated with live loan checks. Fraud did not appear to be a widespread problem, although there was some concern among industry officials about how a potential borrower might be inconvenienced by fraud. First Chicago, however, discontinued making the loans because the losses during a pilot program were "not acceptable."

Borrowers Experienced Benefits and Risks With Live Loan Checks

In the view of lenders, borrowers enjoyed benefits and risks comparable to those associated with conventionally marketed unsecured loans. Borrowers accepted unsecured live loan checks at identical or lower interest rates than the recipient would receive at a local loan office of the lender. These loans had predictable, fixed monthly repayment terms of 48 to 60 months. According to lenders, borrowers experience little risk beyond that normally associated with a loan because they are protected against all liability from fraud or misuse.

Some public and private sector officials said that live loan checks could potentially increase the possibility of default and bankruptcy if the borrower misused credit by running up credit card balances. The executive director of CFA said that live loan checks would only compound the problems created by the abundance of unsecured, high-cost credit card debt. Two lenders, however, said that there was no evidence to show that borrowers would file for bankruptcy quicker as a result of accepting live loan checks instead of using credit cards.

To date, it does not appear that many potential borrowers have been exposed to the risk of fraudulently cashed loan checks. Lenders we spoke with told us that the bank does not hold a consumer responsible if the check mailed to that consumer is deposited or forged by another individual. For example, Chase officials told us that, in the event that a live loan check were stolen, the intended recipient would not be charged if he or she signed an affidavit stating that the check had not been cashed by him or her.

AFSA officials said that state and federal laws shield consumers from liability related to live loan checks and that lenders' credit selection practices help reduce the rate of fraud. AFSA reported that the actual fraud on live loan checks has been extremely low, less than one-tenth of one percent of total mailings. AFSA believes that its voluntary standards ensure minimum inconvenience to the consumer in the event that a check is not cashed by the intended consumer.

Public and private sector officials have not seen large levels of fraud involving live loan checks. OCC had no reported cases of fraudulent acts of cashing a live loan check. Federal Reserve officials said they do not believe that there is a significant problem with losses associated with live loan checks. Federal Reserve officials noted that the primary reason for the low rate of fraud is that rules governing check cashing practices act to deter fraud. The recipient's rights in the case of a forged endorsement are generally governed by state law. Articles 3 and 4 of the Uniform Commercial Code have been adopted in almost every state and determine check negotiation procedures and liability for invalid checks. FTC and Federal Reserve officials said that they had not received many complaints about live loan checks that involved theft and fraud issues over a 2-year period. The executive director of CFA testified, however, that the consumer may experience considerable inconvenience if the live loan check is cashed by someone other than the intended recipient, and believed that a consumer should not experience any inconvenience if fraud occurs.

Lenders Using Live Loan Checks Said They Experienced Benefits and Risks and Absorbed All Fraudulent Losses

Fleet and Chase officials told us that their live loan check programs met corporate profitability requirements and expanded their lines of credit and their loan business. According to bank officials, live loan check programs are attractive because they enable lenders to provide a broader range of consumer loan products.

Lenders viewed live loan checks as a convenient means of delivering a fixed rate, closed ended, unsecured loan product to a consumer. Fleet officials said that live loan checks were moderately profitable loans. They said that the results of these loans were provided monthly to senior management to assess the results against expectations. Chase officials said that a benefit of the bank's loan check program was that the net interest margin for live loan checks was higher than that for mortgage lending. Chase officials told us that prepayment rates for live loan checks are lower than those for mortgages. When interest rates decline, lower payments help cash flows remain more stable, which helps Chase to better manage its loan portfolio. In contrast, a decline in interest rates generally results in a rise in prepayments of some other loans. Chase officials also said that, by using good underwriting practices, they were able to manage credit risk.

With regard to cases involving fraud, both lenders and bank regulatory agency officials said that lenders are to absorb all losses. With 155,000 loans accepted between 1995 and 1997, for example, Fleet reported 68 confirmed cases of fraud. Generally, in these cases, an unauthorized household member cashed the check. In order to prevent fraud, Fleet required that the borrower access funds only by depositing a check into a personal bank account. Once the live loan check was cleared, Fleet created an installment loan for the borrower. To reduce the risk of fraud, Fleet's live loan check offers were only valid for 6 weeks.

Federal bank regulators do not have any special supervisory programs for live loan checks. As noted earlier, OCC officials said that they review these loans in the same way as they do other small consumer loans. Fleet officials told us that monthly reports on these loans, which are distributed to senior Fleet management, are also provided to OCC, Fleet's regulator. Federal Reserve examiners do not specifically monitor live loan check activities at Federal Reserve-regulated institutions. As part of their safety and soundness examinations, Federal Reserve examiners are to review risk models or other risk management systems to assess whether banks practice prudent behavior in their lending.

Little Data Available to Identify Losses Associated With Live Loan Checks

Federal regulatory officials told us that industrywide live loan check activities are not tracked specifically. While Chase officials believed it was too soon to estimate their losses on live loan checks, we received data from Fleet concerning loss rates for its live loan check program.

In 1996 and 1997, according to Fleet officials, the bank's loss rates on live loan checks were lower than the credit card industry national averages. Using year-end balances, in 1996, Fleet said, it experienced a 1 percent loss rate compared to 5.96 percent in the credit card industry. In 1997, Fleet experienced a loss rate of 4.20 percent compared to 6.04 percent in the credit card industry. Fleet projected its 1998 live loan check losses to be similar to the credit card industry's at 5 percent. Fleet officials said that they had set aside adequate reserves to cover anticipated losses. Fleet officials explained that the reason for the reported loss increase for live loan checks from 1996 to 1997 is that, typically, there are not many losses in the early years with a new loan product, and that Fleet was more cautious in marketing live loan checks. In the first year, 1995, Fleet marketed all of its live loan checks to its bank customers. According to Fleet officials, as the loans resulting from their live loan checks begin to mature, losses could increase.

A First Chicago official told us that the bank discontinued its live loan check program because the level of loss was not acceptable. First Chicago conducted a live loan check pilot program in the summer of 1995 to determine whether offering immediate access to funds via checks would increase the likelihood that consumers would borrow money. The actual loss rate was not disclosed to us.

Scope and Methodology

To determine the characteristics of live loan checks, we gathered information on various aspects of individual loans, as well as on the average live loan check profile and the average borrower's profile. To do this, we interviewed officials representing three live loan check lending institutions, an industry association, and a rating agency. We also reviewed publicly available information, including published articles that reported such characteristics. Although we did not independently verify these—or any—industry data, we corroborated evidence with other independent sources whenever possible.

To identify the major organizations that mail live loan checks, we interviewed public and private sector officials. We selected officials to talk to, in part, on the basis of information obtained from other industry sources. For example, we talked with officials at Fleet and Chase. In addition, we spoke with First Chicago officials about whether a live loan check program existed at that institution because officials of other banks had informed us that this institution had cancelled its live loan check program. Moreover, we conducted a literature search and reviewed selected articles that reported on live loan check lenders and their activities. We also spoke to officials representing federal banking and thrift regulatory agencies.

We obtained Fleet's volume of live loan check lending in 1995, 1996, and 1997 and the expected volume in 1998 by interviewing Fleet officials; other lenders were not willing to provide volume data. We attempted to identify comprehensive, industrywide data for the volume of live loan checks by talking with officials representing an industry association, a consumer advocacy group, a rating agency, federal banking and thrift regulatory agencies, and two investment banks. In addition, we contacted officials representing another lender to corroborate information and to obtain additional volume data.

To identify the benefits and risks of live loan checks for borrowers and lenders, we interviewed officials representing federal regulatory agencies and representatives from lending institutions, industry associations, and one rating agency. We reviewed articles and studies that reported benefits and risks associated with live loan check lending. We interviewed public and private sector officials, and reviewed selected federal and state regulations and laws, to gain an understanding of lender protection laws relevant to live loan checks. We also spoke with banking officials about losses associated with live loan checks.

As agreed with your office, unless you announce the contents of this report earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Ranking Minority Member of your Subcommittee, the Chairmen and Ranking Minority Members of other congressional committees with jurisdiction over finanical issues, the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Director of the Office of Thrift Supervision, and other interested parties. We will also make copies available to others upon request.

This report was prepared under the direction of James M. McDermott, Assistant Director, Financial Institutions and Markets Issues. Major contributors include Edwin J. Lane, Evaluator-in-Charge; Mitchell B. Rachlis, Senior Economist; and Becky K. Kennedy, Senior Evaluator. If you have any questions about this report, please call me on (202) 512-8678.

Sincerely yours,

Susan S. Westin

Susan S. Westin
Associate Director, Financial Institutions
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