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An LRO Backgrounder

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Payday Loans

An LRO Backgrounder



Prepared and designed by

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Travis Moore

Research Analyst

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Introduction

Quick and easy access to cash has become a way of life. However, a sizable segment of society lacks the ability to open up a bank account, sign up for a credit card, or take out other lines of credit.

Very few available resources for financial services exist for these individuals, and those that do, are fraught with problems and challenges.

Payday lending is a primary resource for people who fall into this category. How this industry operates, the conditions by which they lend money, and the protections available to the consumer vary depending upon where you live.

Payday Loans: An LRO Backgrounder provides a brief overview of the payday lending industry in the United States, with specific emphasis on (1) the policy considerations of Congress and federal regulators, (2) legislative action considered and taken by the Nebraska Legislature and Nebraska voters, and (3) the innovative and thoughtful approaches taken by other states to protect consumers.

This reports concludes with policy considerations for both lawmakers and consumer advocates.



Common Characteristics of a Payday Loan

According to the Consumer Financial Protection Bureau (CFPB), there is no single definition for a “payday loan.” Other names for payday loans are cash advance, payday advance, short-term loan, fast cash, small-dollar loan, or delayed deposit transaction.

Essentially, a payday loan is an unsecured loan that requires a claim to the borrower’s bank account with a post dated check or electronic debit authorization. Typical loan amounts are for \$500 or less, for which the lender charges a one-time fee of \$10 to \$20 per \$100 borrowed for a two-week period. This is the equivalent of a 391 percent annual percentage rate (APR).

Payday loans are advertised as quick and temporary solutions to cover unexpected expenses. Unlike a traditional financial institution, payday lenders do not require a background check or good credit. To apply for a loan, individuals must show only that they have a source of income and a bank account. Because of this, critics say, payday loans are primarily marketed to financially vulnerable consumers who often cannot repay the full balance when the loan comes due.

Lenders expect full repayment at the borrower’s next payday. Failure to repay results in the lender depositing the borrower’s check or making an electronic withdrawal from the borrower’s bank account. If the borrower cannot repay the loan at the end of the two-week period, he or she can pay another one-time fee to extend the term of the loan.

Payday loan companies have traditionally operated out of storefronts, and some states require lenders to maintain a physical presence in order to provide lending services. However, more and more payday lenders have expanded to offering online services.



Historical Overview of Payday Lending

Twenty-first century borrowers enjoy numerous financial protections. But that was not always the case. In the early 1890s, so-called salary lenders offered loans for a one-week period and charged an APR of 120 percent to 500 percent. As a way of collecting repayment, salary lenders garnished wages. If garnishment did not work, lenders employed other questionable tactics, such as public shaming or extortion.

Legislators implemented policies to discourage the practice of salary lending while also expanding access to consumer credit from licensed lenders. The first of these policies was the Uniform Small Loan Law enacted in 1916, which permitted an interest rate of up to 3 ½ percent for loans of \$300 or less. Thirty-two of the existing 48 states adopted a version of the Uniform Small Loan Law, permitting anywhere from an 18 percent to 42 percent interest rate.

The birth of the consumer credit industry occurred during the mid-20th century with the development of home mortgages and credit cards. As more national lenders entered the market, state laws became ineffective at regulating the industry.

During the 1970s and 1980s, Congress significantly scaled back regulations on federally insured lenders and financial institutions. The federal deregulation of lenders emboldened some institutions to ignore state interest rate laws and led some state legislatures to deregulate state-based lenders.

In the early 1990s, state legislators followed the federal government's lead and allowed special exemptions to state lending laws that authorized small-dollar loans. A majority of states enacted permissive laws that allowed for single-repayment loans with an APR of 391 percent or higher.

In the early 2000s, some states repealed payday lending statutes or adopted tougher regulations in order to reduce fees, regulate loan usage, or reduce repayment periods.

Federal Regulation of Payday Loans

Over the last two decades, Congress enacted several pieces of payday lending reform.

The John Warner National Defense Authorization Act for Fiscal Year 2007 (H.R. 5122) capped interest rates on payday loans provided to military service members and their immediate family members.

In response to the 2008 financial crisis, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act in 2010. The act established the Consumer Financial Protection Bureau (CFPB) and tasked it with protecting consumers in the financial products and services market. Beginning in 2013, the CFPB began accepting consumer complaints against payday lenders.

Concerns remained over the alleged predatory practices of payday lenders, forcing Congress and the CFPB to consider implementing tougher consumer protections or completely restructuring lending practices for small-dollar loans.

In October 2017, the CFPB issued a final rule asserting that it was “an unfair and abusive practice” for payday lenders to make certain types of short-term, small-dollar loans “without reasonably determining that consumers had the ability to repay the loans,” a process known as underwriting.¹ The rule mandated underwriting provisions, but also exempted some short-term, small-dollar loans made with certain loan features. Additionally, this rule sought to limit the practice of lenders making multiple attempts to debit payments from a borrower’s bank account, a practice that resulted in the borrower incurring more fees and being forced to close his or her account. The compliance deadline for this rule was August 19, 2019.²

The CFPB intended this rule to end the predatory practices of payday lenders and stop the cycle of debt borrowers often experience. Payday lenders feared this rule would destroy the payday loan industry, forcing businesses to close and limiting access to loans for people with no other options.³

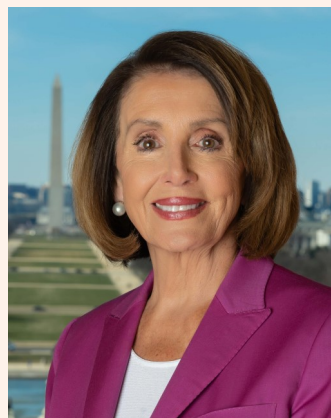
However, before the rule took effect, the CFPB issued a final rule rescinding mandatory underwriting and delaying the compliance deadline to November 19, 2020.

Other federal agencies are also involved in regulating the payday loan industry.

The Federal Trade Commission (FTC) enforces consumer protection laws and has filed a number of law enforcement actions against payday lenders for (1) engaging in deceptive or unfair advertising and billing practices that violate the Federal Trade Commission Act; (2) failing to comply with the disclosure requirements of the Truth in Lending Act; (3) violating the Credit Practices Rule’s prohibition against wage assignment clauses in contracts; (4) conditioning credit on the preauthorization of electronic fund transfers that violate the Electronic Fund Transfer Act; and (5) employing unfair, deceptive, and abusive debt collection practices.⁴

Several federal agencies— the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration, and the Office of the Comptroller— provided guidance in May 2020 for banks and credit unions to offer affordable small-dollar installment loans or lines of credit. However, consumer protection advocates expressed concerns this could lead some banks to issue deposit advance loans with three-digit APRs.⁵

As a result of limited protections enacted by Congress, the payday loan industry remains primarily regulated at the state level.



Nancy Pelosi



Mitch McConnell

Payday Lending in Nebraska

The Nebraska Legislature adopted the Delayed Deposit Services Licensing Act⁶ in 1994 to provide for the licensure of short-term lenders and to regulate the payday lending industry.

In order to operate a payday lending service, the act⁷ required lenders to:

- ◆ Obtain a license from the Nebraska Department of Banking and Finance;
- ◆ Pay a nonrefundable application fee of \$300;
- ◆ Provide a surety bond of \$50,000, which is renewed or refiled by May 1 each year;
- ◆ Provide proof of having available assets of at least \$25,000;
- ◆ Pay an application fee of \$150 for each additional branch location;
- ◆ Provide services only at the principal place of business listed on the license application or at a licensed physical branch office; and
- ◆ Only operate branch offices in the same county as the principal place of business.

In addition, a licensed lender cannot:

- ◆ Hold more than two checks from a single borrower at one time;
- ◆ Hold checks from a single borrower in an amount in excess of \$500;
- ◆ Hold checks for more than 31 days;
- ◆ Require borrowers to receive payment through a method which forces them to pay additional charges or fees; and
- ◆ Accept a check already held by the same licensed operator as a method of repayment or refinancing or for the consolidation of checks.

Anyone operating a payday lending service without a license or while his or her license is suspended or revoked can be found guilty of a Class IV felony.

The act also required the lender to provide written notice to the borrower. The written notice must include the (1) fee to be charged; (2) date on which the check will be deposited; and (3) amount of any penalties charged, not to exceed \$15 per \$100 borrowed. In addition to the written notice requirement, a schedule of all fees, charges, and penalties for services must be conspicuously displayed in each business location.

A number of changes have occurred since the adoption of the original act in 1994.

In 2000, the Legislature added a provision requiring checks in the collection process that are not negotiable on the agreed-upon day cannot be considered as being held in excess of the 31-day limitation.⁸

In 2006, legislators extended the length of time, from 31 to 34 days, that lenders can hold checks. The bill also contained provisions prohibiting lenders from renewing, rolling over, deferring, or extending payday loan transactions by allowing borrowers to pay less than the total amount of the check and any associated fees or charges. Lenders are also restricted from entering into another payday loan transaction with the same borrower on the same business day unless both parties can verify completion of the previous payday loan.⁹

In 2012, legislators increased both the \$150 main office renewal fee and the \$150 branch office renewal fee to \$500.¹⁰

Under the terms of legislation in 2018, payday loans provided by an unlicensed person are void and lenders have no rights under the law to collect, receive, or retain any principal, interest, or fees. A fee exemption was also added for active duty members of the military and their spouses or dependents.

Legislators also amended the language for the written notice requirement to the borrower in 2018.

The notice must include: (1) the name of the borrower, the transaction date, and the amount of the loan; (2) the payment due date and total amount due; (3) fee totals on the transaction, expressed in a dollar amount and as an APR; (4) the date on which the check will be deposited or presented for negotiation; and (5) any penalties charged (not to exceed \$15), if the check is not negotiable on the agreed upon date.¹³

Neb. Rev. Stat. sec. 45-917 requires that notices given pursuant to law should be all capitalized, in at least ten-point font, and include the following language:

- 1. THIS TYPE OF SERVICE SHOULD BE USED ONLY TO MEET SHORT-TERM CASH NEEDS.**
- 2. THE LAW DOES NOT ALLOW THIS TYPE OF TRANSACTION TO BE MORE THAN FIVE HUNDRED DOLLARS (\$500) IN TOTAL, INCLUDING FEES AND CHARGES, FROM ONE LENDER.**
- 3. YOU HAVE THE RIGHT TO RESCIND THIS TRANSACTION IF YOU DO SO BY THE NEXT BUSINESS DAY BEFORE 5 P.M.**
- 4. YOU HAVE THE RIGHT TO RESCIND YOUR AUTHORIZATION FOR ELECTRONIC PAYMENT.**

Legislation adopted in 2020 amended the Delayed Deposit Services Act to require state licensed lenders to be licensed and registered through the federal Nationwide Mortgage Licensing System and Registry.

The 2020 legislation change also allows a borrower who cannot repay the loan to elect (once in any 12-month period) to repay the loan via an extended payment plan. The borrower must request an amendment to the loan agreement before repayment is due, and the amendment must reflect the new payment schedule and terms. Under the terms of the extended payment plan, the borrower must have the opportunity to repay the outstanding loan and original fees, at no additional cost, in at least four equal payments. The borrower can prepay without penalty, and the lender cannot charge the borrower interest or additional fees during the term of the extended payment plan.

Failure to pay under the terms of the extended payment plan results in the borrower being in default, upon which the lender is authorized to accelerate payment on the remaining balance and can take action to collect all amounts owed.

Despite changes enacted by the Legislature, policy analysts with The Pew Charitable Trusts (Pew) considered Nebraska law to be very permissive.¹⁴

PAYDAY LOAN STORES IN NEBRASKA

Alliance: 1	Fremont: 3	Lexington: 2	Ogallala: 1	South Sioux City: 1
Beatrice: 1	Grand Island: 6	Lincoln: 20	Omaha: 31	York: 1
Bellevue: 6	Hastings: 2	Nebraska City: 1	Papillion: 1	Total: 102
Chadron: 1	Kearney: 4	Norfolk: 3	Scottsbluff: 3	
Columbus: 5	La Vista: 3	North Platte: 5	Sidney: 1	

Source: Nebraska Department of Banking and Finance (As of May 1, 2020)

Nebraska Citizens Take Action

In 2019, a coalition of citizens and organizations concerned about payday lending practices formed Nebraskans for Responsible Lending, with the intent of getting reforms before voters via an initiative petition. The committee filed proposed petition language with the Nebraska Secretary of State in September 2019 and began collecting signatures to place Initiative Measure 428 on the 2020 General Election ballot.

Circulators of the payday lending petition were required to collect at least 85,628 signatures in order for the measure to appear on the ballot. The coalition met this goal with 94,468 signatures verified in 46 counties (exceeding the state's five percent signature distribution requirement ¹⁵).

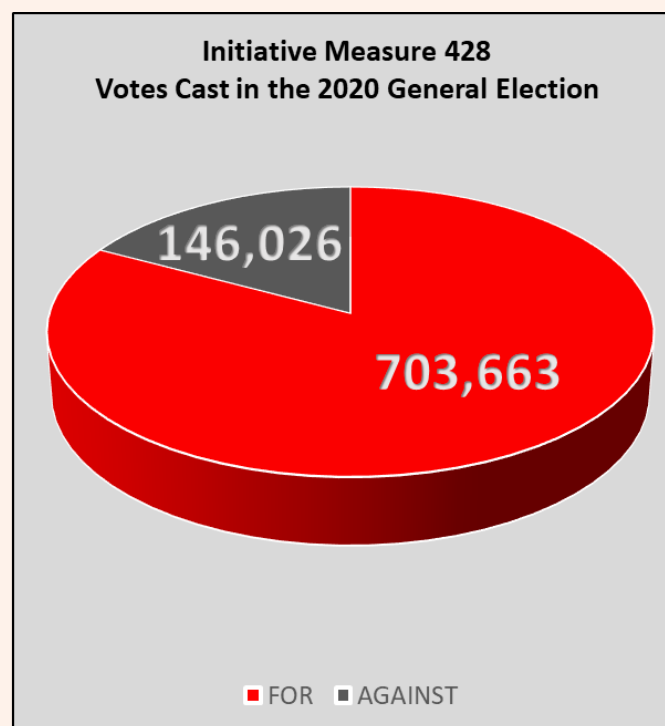
The measure's supporters argued that Nebraskans needed payday lending reform to enhance consumer protections and ensure that individuals who do not qualify for traditional bank loans do not have to take out high-interest loans, potentially trapping them in a cycle of debt.

Opponents, primarily people in the payday lending industry, said the proposed ballot measure would disproportionately affect lenders in rural Nebraska, force small-dollar lending businesses to close, and leave people with no credit or damaged credit with fewer loan options.

Voters approved the measure, making Nebraska the 17th state to cap payday loans at 36 percent.

Results from the 2020 General Election were certified by the State Canvassing Board on November 30, 2020. The Governor issued a proclamation on December 8, 2020, declaring Initiative Measure 428 passed and in effect.

Initiative Measure 428 removes the fee of \$15 per \$100 borrowed and caps APR— including all fees, interest, and charges ¹⁶— at 36 percent. Payday loans issued in violation of the interest cap are uncollectable. Lastly, the measure extends the APR cap to all methods of providing payday loans.



Payday Reform in Other States

According to the National Conference of State Legislatures, approximately 16 states have outright banned payday lending, while others have enacted various reforms.

Reforms taken in three of these states are highlighted in this section.



Colorado first enacted payday lending in 1992, placing the practice under the state’s Uniform Consumer Credit Code. In 2000, legislators exempted payday lenders from interest rate caps imposed on other lenders.

COLORADO



The state’s payday lending legislation permitted a maximum loan of \$500, authorized lenders to charge \$75 per pay period, required lenders use a postdated check or electronic debit authorization, and did not allow for amortization of the principal. The average APR in Colorado was 319 per-

cent.

Concern grew as (1) borrowers spent more in fees and penalties than the original amount of the loan, (2) more loans were taken out for longer than the initial two weeks, and (3) borrowers relied on additional loans in order to repay debt. Unsuccessful attempts were made in 2008 and 2010 to remove the interest rate cap exemption.

In 2010, legislators enacted the Deferred Deposit Loan Act, to make loans more affordable for Colorado citizens. The new law eliminated conventional, lump-sum loans and replaced them with six-month, deferred deposit loans.¹⁷

Cost to Borrow \$500 in Colorado¹⁸

	Before law change	After law change
For 2 weeks	\$75	\$10
For 3 months	\$450	\$125
For 6 months	\$975	\$290
For 12 months	\$1950	\$580

The act allowed lenders to charge a 45 percent APR, a refundable origination fee, and a monthly maintenance fee (a combined average APR of 129 percent). Borrowers who prepaid before the loan expired could do so without penalty.

According to Pew, the practice of prorating the origination fee for early loan repayment ensures that lenders do not immediately receive this money and eliminates an incentive to extend loans and collect new fees.

As a result of these changes, lenders modified their business models, which resulted in the consolidation of storefronts and increased the number of customers served per storefront.

**Prior to 2010, there were 505 licensed payday lenders in Colorado.
As of 2013, only 238 licensed lenders remained.**¹⁹

Pew's extensive study of Colorado's new law concluded: (1) loan payments are more manageable based on a borrower's ability to repay; (2) interest rates are comparatively lower than before and are far lower than national interest rates; (3) lower interest rates reduced the overall cost to the borrower; (4) allowing the principal to decline with each installment increased a borrower's ability to pay off the loan sooner; and (5) access to small-dollar lending services was not hindered.²⁰

Despite attempts to impose tougher restrictions, the average APR in Colorado in 2016 was 129 percent and over 200,000 people still relied on payday loans. These factors resulted in a 2018 ballot measure to impose additional payday loan limitations.

Proposition 111 received 77 percent approval from Colorado voters and took effect on February 1, 2019.²¹ The new law places a 36 percent APR cap on payday loans and prohibits the collection of other finance charges and fees.

During an interview with Colorado Public Radio, Pew's Alex Horowitz, said of the new Colorado law: "In 15 other states that have a similar law on the books, there are no payday loan stores. There won't be payday loans anymore in Colorado."²²



Ohio earned a reputation as one of the worst states with regard to payday lending practices, offering some of the nation's most expensive loans. Lenders in the state charged four times as much in interest as in other states and over 90 percent of the market was controlled by six payday loan companies. According to consumer advocates in the state, loan payments consumed more than one-third of a borrower's paycheck.

In 2008, Ohio voters approved a ballot initiative capping payday loan interest rates at 28 percent. However, by registering as a "broker", payday lenders were no longer subject to the state's interest cap and unrestrained in the amount they could charge.

Community leaders and consumer protection advocates partnered with Pew and made their case for payday lending reform, which resulted in the introduction of H.B. 123 in 2017. Due in part to bipartisan collaboration, statewide support, and the tireless efforts of reform advocates, the Fairness in Lending Act passed and took effect on October 29, 2019. However, the act did not apply to new loans or credit extensions until April 27, 2019.²⁴

The act made the following changes:²⁵

- ◆ Increased the maximum loan amount from \$500 to \$1,000;
- ◆ Restricted the minimum duration of a loan to 91 days and increased the maximum duration to one year;
- ◆ Authorized loans for a period of less than 91 days, if the loan did not exceed six percent of a borrower's gross monthly income or seven percent of a borrower's net monthly income;
- ◆ Allowed a borrower to rescind or cancel a payday loan contract on or before 5 p.m. of the third business day following the loan transaction;

- ◆ Restricted the amount of fees and charges to (1) an interest rate not to exceed 28 percent per year, (2) a monthly maintenance fee, (3) a loan origination charge on loans of \$500 or greater, (4) a single check collection charge, and (5) a check cashing fee;
- ◆ Prohibited the total amount of fees and charges from exceeding 60 percent of the originally contracted loan amount;
- ◆ Permitted loan refinancing, as long as the lender did not charge a monthly fee on the refinanced loan;
- ◆ Required lenders to provide a prorated refund on loans that are prepaid in full or refinanced prior to the maturity date;
- ◆ Prohibited lenders from providing loans when the loans result in a total outstanding principal of more than \$2,500;
- ◆ Removed the requirement that payday lenders be located in state and can only provide loans to borrowers physically present in the storefront; and
- ◆ Removed the prohibition on lenders making or offering loans online.

The payday reform law adopted in Ohio was an innovative approach to enact stronger consumer protections and expanded authority over regulators to oversee lenders. The act's goals were to make payday loans more affordable to borrowers while allowing lenders to earn a profit. Pew researchers estimate Ohioans will save at least \$75 million a year.²⁶



According to the Virginia Poverty Law Center, until recently Virginia had some of the weakest consumer protection laws in the nation. Payday lenders avoided consumer protection laws by structuring loans as lines of credit with no interest limits (one of only six states to allow this practice). Payday lenders also charged unlimited interest on loans in excess of \$2,500 (a practice banned in 40 states²⁷).

In 2008 attempts to reform the state's payday lending statutes were unsuccessful.

But in 2019, the Virginia legislature passed a consumer lending reform bill that becomes effective January 1, 2021.²⁸

Virginia's new payday lending law makes the following changes:

- ◆ Replaces the term "payday loans" with "short-term loans";
- ◆ Imposes a cap on interest and fees at 36 percent, plus a maintenance fee;
- ◆ Increases the maximum loan amount from \$500 to \$2,500;
- ◆ Sets the minimum loan period at four months and the maximum loan period at 24 months;
- ◆ Prohibits lenders from collecting fees and charges that exceed 50 percent of the original loan amount for loans equal to or less than \$1,500; and

- ◆ Prohibits lenders from collecting fees and charges that exceed 60 percent of the original loan amount for loans greater than \$1,500.

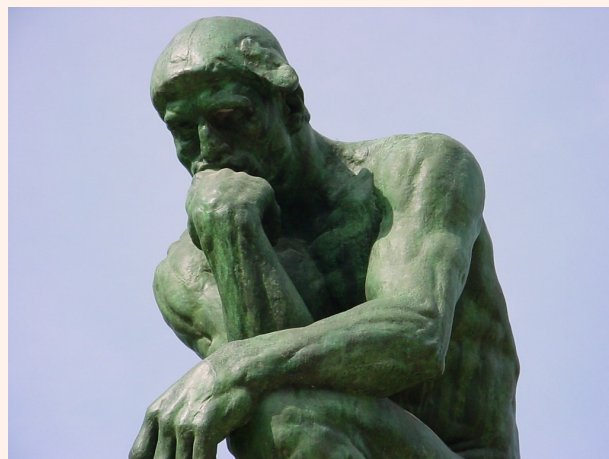
Short-term lenders must make reasonable attempts to verify a borrower's income before providing a loan. Additionally, lenders are prohibited from advertising or providing additional services related to credit extension that have an APR in excess of 36 percent, are for less than \$5,000, have a term of less than one year, or are already provided for under the state's open-end credit plan.²⁹

According to analysis by Pew, the actions taken by Virginia policymakers are projected to save Virginia families an estimated \$150 million per year, while still maintaining a viable lending market and expanding access to affordable credit.

For Your Consideration

Substantive federal reform or additional regulation of the payday lending industry seems unlikely in the near future. This puts greater emphasis on policy deliberation at the state level.

As Nebraska legislators monitor the implementation of Initiative Measure 428 and consider additional payday regulations, it is important to consider the three indicators of safe small-dollar lending practices: (1) lower overall costs; (2) affordable payments; and (3) reasonable re-payment periods.³⁰



Additionally, policymakers must study the role that payday lenders and other small-dollar lenders play for individuals with nonexistent or damaged credit, as well as consider what alternative options are available to them for loans or lines of credit.

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