

Client Alert

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The CFPB's Payday Lending Rulemaking is Here With Sweeping Implications for the Short-Term Credit Industry

By Leonard N. Chanin, Orea O. Poindexter, and Joe Rodriguez

On June 2, 2016, the Consumer Financial Protection Bureau ("CFPB") released its long-anticipated Notice of Proposed Rulemaking ("Proposed Rule") on short-term lending. While we will be doing further analysis on the rule, it appears to generally track the Outline of Proposals Under Consideration and Alternatives Considered released by the CFPB in March 2015. Comments on the proposal are due on September 14, 2016.

In prepared remarks at a field hearing in Kansas City, Missouri, Director Richard Cordray announced the proposed rulemaking, citing a need to protect consumers from harmful short-term lending practices.

Today the Consumer Bureau is taking the next step, adding new federal protections against lending practices that harm consumers by trapping them in debt they cannot afford. These strong, common-sense protections would apply mainstream lending principles to payday, auto title, and certain other high-cost installment and open-end loans. Traditional lenders, such as community banks, credit unions, and many finance companies, make an effort to determine a borrower's ability to repay before offering a loan with affordable payments. Both the lender and the borrower have a mutual stake in one another's success. But today, the borrower's ability to repay is often entirely absent from the transaction when it comes to payday and other similar loans.

The Proposed Rule is the first federal rulemaking focusing specifically on the short-term lending industry — an industry that traditionally has been governed by state law. Announcing the Proposed Rule primarily pursuant to Title X, Section 1031, of the Consumer Protection Act of 2010 ("Act"), the CFPB cited its authority to "identify and prevent unfair, deceptive, or abusive acts or practices in the consumer financial markets" ("UDAAP"). This is significant, as it marks the first time the CFPB has used its UDAAP authority for rulemaking purposes.

The CFPB's Proposed Rule weighs in at 1,334 pages; we will provide a more detailed analysis of the Proposed Rule in another alert.

WHO IS COVERED UNDER THE PROPOSED RULE?

Although the rulemaking has been characterized as the "payday loan rule," it is sweeping in terms of the products covered and the limitations it would impose on the short-term consumer lending industry generally.

The Proposed Rule would apply to both open- and closed-end payday loans, auto title loans, deposit advance products, and certain so-called "high-cost" installment loans. In addition, the Proposed Rule would apply to "lenders," including bank and nonbank lenders, as well as FinTech and marketplace lenders, if they regularly make "covered loans" for personal family or household purposes. In this regard, under the Proposed Rule, loans are classified as either short-term or longer-term loans (collectively, "covered loans").

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- *Covered Short-Term Credit Products Defined:*

Loans with contractual durations of 45 days or less, including payday loans with a single payment, short-term vehicle title loans, and open-end credit lines where the credit terminates within 45 days of origination.

- *Covered Longer-Term Credit Products Defined:*

Loans with durations of more than 45 days that have (1) a total cost of credit in excess of 36 percent (including various fees imposed in connection with the loan); and (2) either a lien or other security interest in the consumer's vehicle or a form of "leveraged payment mechanism" providing the lender a right to obtain repayment through the consumer's account or to obtain payment via payroll deduction or other direct access to the consumer's paycheck. This definition also includes a subcategory of loans with a balloon payment.

The Proposed Rule excludes certain consumer credit products from the scope of the proposal, including: (1) loans extended solely to finance the purchase of a car or other consumer good in which the good secures the loan; (2) home mortgages and other loans secured by real property or a dwelling if recorded or perfected; (3) credit cards; (4) student loans; (5) nonrecourse pawn loans; and (6) overdraft services and overdraft lines of credit.

PATHS TO COMPLIANCE

The Proposed Rule is complex, articulating a primary method of compliance involving an ability-to-repay determination, but also providing models of compliance for covered loans as an alternative to the specific ability-to-repay requirements in the Proposed Rule.

Full Payment Test, A/K/A Ability-to-Repay Determination

Under the Proposed Rule, it would be considered an abusive and unfair practice for a lender to make a covered loan without reasonably determining that the consumer will have the ability to repay the loan. However, the proposal does not provide a specific debt-to-income ratio or other "safe harbor" measurement for determining if a lender has satisfied the ability-to-pay test.

In examining a consumer's ability to repay, a lender would be required to consider and verify the amount and timing of the consumer's income, the consumer's major financial obligations, and the consumer's borrowing history. Moreover, the lender would be required to determine that the consumer could afford to make the payments including the consumer's "major financial obligations," payments under the covered loan, and for basic living expenses such as food and utilities. This analysis would require lenders to use information from at least one credit bureau. The ability-to-repay determination for longer-term loans would largely track this approach, with the added requirement that the lender reasonably account for the possibility of volatility in the consumer's income, obligations, or basic living expenses during the term of the loan. Of note, according to the Proposed Rule, a lender's ability-to-repay determination may not be deemed reasonable if its borrowers consistently reborrow or default.

A lender also would have to make certain assumptions or presumptions when evaluating a consumer's ability to repay. For example, if a consumer sought to take out another covered loan within 30 days of a covered short-term loan or a covered longer-term loan with a balloon payment, the lender would be required to presume that the consumer is not able to afford the new loan. Additionally, a presumption of unaffordability would apply if the consumer had demonstrated difficulty in repaying other outstanding covered or noncovered loans made by the

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same lender or its affiliate. This presumption of unaffordability for a new covered loan could be overcome only if the lender were able to document a sufficient improvement in the consumer's financial situation. Moreover, under the Proposed Rule, a lender would be prohibited from making a covered short-term loan to a consumer who has already taken out three covered short-term loans within 30 days of each other.

Information Furnishing to Registered Information Systems

According to the Proposed Rule, in order to determine whether a consumer has the ability to repay a covered loan, the lender must have access to "reasonably comprehensive information about a consumer's current and recent borrowing history, including covered loans made to the consumer by other lenders, on a real-time or close to real-time basis." Therefore, the Proposed Rule would require lenders to furnish certain information about covered loans to each "registered information system" — consumer credit reporting agencies that register with the CFPB pursuant to the Proposed Rule and are deemed by the Bureau to be able to receive and report information regarding covered loans, as well as maintain a "certified" compliance management program and certain data security protocols. These registered information systems would be credit reporting agencies under the Fair Credit Reporting Act ("FCRA"), and the requirement to furnish information would require lenders to comply with furnisher obligations under the FCRA.

Consequently, any lender making a covered loan to a consumer would be required to obtain a consumer report from a registered information system, which would contain information about a consumer's borrowing history, regardless of which lender made a previous covered loan to the consumer. By obtaining the consumer report from a registered information system, the lender would receive the necessary information on a consumer's borrowing history to utilize in its ability-to-repay analysis.

Alternatives to Ability-to-Repay

The Proposed Rule would provide lenders with alternatives to the ability-to-repay determination for covered loans that meet specific structural requirements, as well as certain consumer screening and disclosure requirements. The ability-to-repay alternatives would be different for short-term and long-term products.

Short-Term Products - Principal Payoff Option

Under the short-term products alternative to the ability-to-repay requirement, a lender would be allowed to make up to three covered short-term loans in succession, so long as the initial loan had a principal amount of \$500 or less, the second loan had a principal amount at least one-third smaller than the principal amount on the first loan, and the third loan had a principal amount at least two-thirds smaller than the principal amount on the first loan. In other words, each successive loan must reduce the principal owed by at least one-third. In addition, certain disclosures would have to be provided to the consumer about the loans.

Among other conditions, the lender must verify the consumer's borrowing history, including confirming that a borrower does not have an outstanding covered loan with any other lender. Furthermore, a lender would not be allowed to make a covered short-term loan if it would result in the consumer having more than six covered short-term loans during a consecutive 12-month period, or being in debt for more than 90 days on covered short-term loans during a consecutive 12-month period. Additionally, the lender would not be permitted to take vehicle security in connection with these loans.

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Longer-Term Credit Products – Two Alternatives

For longer-term loans, a lender has two alternatives to the ability-to-repay requirement. First, a lender can offer longer-term loans that are modeled on the National Credit Union Administration's regulations for the Payday Alternative Loans ("PAL") program. Under this alternative, a covered longer-term loan would be required to have a principal amount of not less than \$200 and not more than \$1,000, fully amortizing payments, and a term of at least 46 days but not longer than six months. These loans could not have an interest rate that is more than the permitted rate for federal credit unions to charge under the PAL regulations (currently 28 percent) and an application fee of no more than \$20.

Second, a lender would also be permitted to make a covered longer-term loan, without having to satisfy the ability-to-repay requirement, if the covered longer-term loan met proposed structural conditions. Specifically, a covered longer-term loan would be required to have fully amortizing payments and a term of at least 46 days but not longer than 24 months. The loan must also carry a total cost of credit of no more than an annual rate of 36 percent (including various fees), from which the lender could exclude a single origination fee that is no more than \$50, or that is reasonably proportionate to the lender's costs of underwriting. The projected annual default rate on all loans made pursuant to this specific exemption must not exceed 5 percent.

PAYMENT PRACTICE RESTRICTIONS

The Proposed Rule also addresses the CFPB's concern that some lenders often make repeated unsuccessful attempts to collect payment on a covered loan from a consumer's checking or savings prepaid account, causing the consumer to incur substantial costs. Specifically, the Proposed Rule would require lenders to notify consumers prior to an attempt to collect payment from a consumer's account, while also limiting the number of unsuccessful collection attempts a lender can make before having to obtain new authorization from the consumer.

Notice Requirements

In general, subject to certain exceptions, the Proposed Rule would require lenders to provide a written or electronic notice to consumers prior to each lender-initiated attempt to collect payment from a consumer's checking, savings, or prepaid account. For electronic notices, the notice would be required at least three business days in advance and no more than seven business days in advance of each attempt to collect payment from a consumer's account, including an attempt to re-present a failed payment.

Limits on Payment Collection Attempts

The Proposed Rule would limit the number of attempts a lender could undertake to collect payment from a consumer's checking, savings, or prepaid account. After two consecutive payment attempts have failed, a lender would be prohibited from making an additional payment attempt without first obtaining a new authorization from the consumer. This limitation would apply to all consumer payment channels.

Effective Date

Under the Proposed Rule, the final rule would be effective 15 months after its publication in the *Federal Register*.

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TAKE-HOME LESSONS

- The Proposed Rule is very broad. Any lenders offering consumer lending products and services, other than those specifically excluded from the rule's coverage (e.g., mortgage loans), will want to examine the rule to see how it may apply to their business.
- The Proposed Rule is likely to have significant ramifications for consumers needing access to short-term liquidity, as it is likely to limit or restrict access to short-term consumer lending products and services.
- While the ability-to-repay requirement is substantial, the alternatives available through careful structuring of loan products may provide some helpful options for the small-dollar lending industry.
- The Proposed Rule not only makes substantial changes to the way small-dollar loans are underwritten and structured, but it also mandates credit reporting and furnishing requirements that will be substantial undertakings in their own right.

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