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Short-Term Lenders Face Costly Path To Compliance

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On June 2, 2016, the Consumer Financial Protection Bureau released its long-anticipated notice of proposed rulemaking on short-term consumer lending. The proposed rule follows the CFPB's March 2015 release of an outline of proposals under consideration on the same topic. Comments on the proposed rule are due on Sept. 14, 2016.

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. Notably, this is the CFPB's first proposed rule based on the agency's power to restrict "unfair, deceptive or abusive" acts or practices (UDAAP).

The proposed rule would impact both open- and closed-end payday loans, auto title loans, deposit advance products, and certain so-called "high-cost" longer-term loans (collectively, "covered loans"). In this regard, under the proposed rule, loans are classified as either short-term or longer-term. The proposed rule would also apply to "lenders," including banks and nonbank lenders, such as fintech and marketplace lenders, if they regularly make "covered loans" for personal, family or household purposes.

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

Longer-term loans are loans with durations of more than 45 days that have (1) a "total cost of credit" in excess of 36 percent and (2) either a security interest in the consumer's vehicle or a form of "leveraged payment mechanism" that provides the lender with 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. Evidently, this latter description includes not only auto-pay or Automated Clearing House (ACH) authorizations, but checks drawn on a consumer's account.

The definition of longer-term loans establishes a requirement to include interest and fees known as "total cost of credit." Under the proposed rule, a lender making longer-term loans will need to compute the "total cost of credit" in addition to other computations for the cost of credit that are already required under federal law, such as the annual percentage rate (APR) under the Truth in

Lending Act and Regulation Z. In this regard, the proposed rule is similar to the Department of Defense's Military Lending Act regulation, in that it requires nonstandard cost-of-credit calculations. Indeed, the "total cost of credit" calculation under the proposed rule is substantially similar to the "military APR" calculation set forth in that rule.

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, part of a 1,334 page issuance, is complex, articulating a primary method of compliance involving an ability-to-repay determination, but also providing alternative models of compliance for covered loans in lieu of ability-to-repay requirements. Therefore, a covered loan could be either a short-term or longer-term loan and, within each of those categories, a loan could be either an "ability-to-repay" loan or a "conditionally exempt" loan, depending on which method of compliance was used to make the loan.

Ability-to-Repay Determination

Under the proposed rule, unless the loan is "conditionally exempt" (as described in more detail below), it would be 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" measurements for determining whether a lender has satisfied the ability-to-repay test.

The proposed rule's requirements for determining a consumer's ability to repay are unlike any other provision of federal consumer financial protection law. The amount and type of consumer-centric data that lenders would be required to consider (and in some instances verify) to establish the consumer's ability to repay are simply unprecedented as credit underwriting criteria. As a practical matter, the CFPB may be pressing creditors to make only "conditionally exempt" loans (described below). At this point, the extent to which either category of loans will prove economically feasible in the marketplace is uncertain.

In determining a consumer's ability to repay, the lender would project the consumer's net income and payments for major financial obligations and use its projections to reasonably conclude that the consumer would be able to make payments for major financial obligations, make payments under the covered loan, and meet basic living expenses such as food and utilities. For longer-term loans there would be the added requirement that the lender must reasonably account for the possibility of volatility in the consumer's income, obligations or basic living expenses during the term of the loan. This projection would need to be based on written statements from the consumer as well as verification evidence, including a reliable record of the consumer's income payments and information from at least one national consumer report.

Under the proposed rule, a lender would be prohibited from making covered loans in certain situations. For example, a lender would be prohibited from making an ability-to-repay short-term loan to a consumer who has already taken out three such loans within 30 days of each other. A lender also would be prohibited from making an ability-to-repay short-term loan if the consumer took out a conditionally exempt short-term loan within the previous 30 days. Similarly, a lender would be prohibited from making an ability-to-repay longer-term loan if the consumer took out a conditionally exempt short-term loan from the lender or an affiliate of the lender within the last 30 days.

Moreover, a lender would also be bound by certain presumptions regarding a consumer's inability to repay. For example, if a consumer sought to take out another covered loan within 30 days of an ability-to-repay short-term loan, or if the consumer had demonstrated difficulty in repaying other outstanding covered or noncovered loans made or serviced by the same lender or its affiliate, the lender would be required to presume that the consumer is not able to afford the new loan. These presumptions of unaffordability could be overcome only if the lender reasonably determines that there will be sufficient improvement in the consumer's financial situation.

Alternatives to Ability-to-Repay

The proposed rule provides lenders with alternatives to the ability-to-repay determination. These conditional exemptions are different for short-term and longer-term products. In addition to specific structural requirements, the conditional exemptions include certain consumer screening and disclosure requirements.

Conditionally Exempt Short-Term Loans

To be a conditionally exempt short-term loan, a loan must be closed-end and the lender must not take a vehicle security in connection with the loan. A lender would be allowed to make up to three conditionally exempt short-term loans in succession, so long as the initial loan had a principal amount of $500 or less, and each successive loan had an at least one-third reduction in the principal owed, as compared to the initial loan. In addition, certain disclosures would have to be provided to the consumer before the first or third loan in a sequence is consummated.

Among other conditions, the lender must verify the consumer's borrowing history, including confirming that a consumer does not have an outstanding short-term loan or ability-to-repay longer-term loan with any other lender. Similarly, the lender must confirm that in the past 30 days the consumer did not have an outstanding ability-to-repay short-term loan or an ability-to-repay longer-term loan with a balloon payment. Furthermore, a lender would not be allowed to make a short-term loan if it would result in the consumer having more than six short-term loans during a consecutive 12-month period, or being in debt for more than 90 days on short-term loans during a consecutive 12-month period.

A March 2014 report by the CFPB found that over 80 percent of payday loans are rolled over within 14 days, and among loans that are rolled over, over 80 percent of the loans have a larger balance on the last loan in the sequence than the first loan.[1] It is clear that the agency relied on this data (which has been questioned by many industry participants) in formulating requirements for conditionally exempt short-term loans. In the proposed rule, the CFPB effectively bans traditional payday lenders from rolling over the full balance of loans because on each loan extension a significant amount of principal would have to be paid down.

Conditionally Exempt Longer-Term Loans — Two Alternatives

For longer-term loans, a lender has two alternative ways of making a conditionally exempt loan.[2] Under the first alternative, a lender can offer closed-end 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 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 longer-term loan can be conditionally exempt from the ability-to-repay requirement if the longer-term loan meets proposed structural conditions. Specifically, a longer-term loan would need to be a closed-end loan, have fully amortizing payments, and have 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 36 percent annually, 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. Because a loan is only a covered longer-term loan if the total cost of credit exceeds 36 percent, this conditional exemption would apply in the narrow set of circumstances in which the origination fee pushes the total cost of credit from at or below 36 percent to over 36 percent. Additionally, for a lender making loans under this conditional exemption, the lender must maintain an underwriting method that results in an annual default rate of 5 percent or less on the portfolio of loans made pursuant to this conditional exemption. As such, creating a profitable underwriting method that achieves a 5 percent default rate may prove a difficult task for lenders.

Moreover, this second option for conditionally exempt longer-term loans is a departure from the CFPB’s March 2015 outline of proposals, which had suggested the bureau’s proposal would provide a conditional exemption for loans structured with a payment-to-income (PTI) ratio of less than 5 percent. This anticipated maximum PTI conditional exemption was seen by some banks as a potential means of entering the short-term lending market, and its absence from the proposed rule was particularly noticeable. That said, the PAL option, which at its shortest term and smallest dollar amount allows for APRs in excess of 100 percent, may yet provide an opportunity for banks — as well as fintech and marketplace lenders — to strategically enter this market.

Additional Requirements for Covered Loans and Lenders

Payment Collection Activities

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 at least three business days in advance and no more than seven business days 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 to two before having to obtain new authorization from the consumer.

Information Furnishing to Registered Information Systems

Lender 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” is a fundamental requirement of the proposed rule’s consumer protection mechanisms. However, a central credit reporting system that comprehensively covers short-term loans nationwide as required by the proposed rule does not currently exist, so the proposed rule creates one.[3]

Specifically, the proposed rule would require lenders making any covered loans, except certain conditionally exempt longer-term loans, to furnish information about the loans to each "registered information system." Registered information systems are consumer reporting agencies that register with the CFPB pursuant to the proposed rule and are deemed by the CFPB 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 consumer reporting agencies under the Fair Credit Reporting Act, 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 or conditionally exempt compliance analysis.

Compliance Program

Lenders making covered loans must develop and follow written policies and procedures that are reasonably designed to ensure compliance with the proposed rule. Given the complexity of the proposed rule, such compliance management systems will be costly and difficult to create.

Liability and Private Rights of Action

The CFPB issued the proposed rule pursuant to Title X, Section 1031, of the Consumer Protection Act of 2010, which grants the CFPB the authority to "identify and prevent unfair, deceptive, or abusive acts or practices in the consumer financial markets." This is the first time the CFPB has used its UDAAP authority for rulemaking purposes. That authority does not include a private right of action, nor does the proposed rule affirmatively suggest one exists. However, lenders should be mindful of state consumer credit laws, which hold that a violation of federal law may constitute a violation of a state UDAP or other consumer protection law. If such a state law allows for a private right of action, consumers and plaintiffs attorneys may have a separate avenue of attack.

Prohibition on Evasion

Somewhat circularly, the proposed rule prohibits evasion of the rule. The proposed official interpretation additionally states that the actual substance of a lender's actions, as well as relevant facts and circumstances, are relevant to determine whether a lender is evading the requirements. The proposed official interpretation goes on to provide examples of inventive loan structures that might technically result in loans that are not covered by the rule, but were not so structured solely for legitimate business purposes, and therefore may be deemed to be evading its requirements. Moreover, since the proposed rule is promulgated pursuant to the CFPB's UDAAP authority, such a violation would also by definition be a violation of the Dodd-Frank Act, which includes penalties for knowing conduct of up to $1 million per day.

Take-Home Lessons

- The proposed rule is exceedingly complicated and largely unprecedented. Any lender offering consumer lending products and services, other than those specifically excluded from the rule's coverage (e.g., mortgage loans, student loans and credit cards), will want to examine the proposed rule to see how it may apply to its consumer credit business. For example, it appears that consumer finance lending, which has been regulated under state laws for generations, would be captured and regulated by the proposed rule.

- 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. In effect, the proposed rule aims to limit access to credit products thought to be inherently unfair and abusive, while leaving limited alternatives for consumers in need of short-term liquidity. For example, the proposed rule lumps deposit advance products previously offered by banks in the same "unfair and abusive" category as payday loans.

- While the ability-to-repay requirement is substantial, the "conditional exemption" alternatives available through careful structuring of loan products may provide options for small-dollar lenders to continue to make consumer loans profitably.

- 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.

- The proposed rule often requires lenders to make "reasonable" determinations. While the proposal and the proposed comments to the rule provide some guidance regarding whether a determination is "reasonable," the term is inherently ambiguous and leaves lenders exposed to regulatory uncertainty. This uncertainty is expected to be manifested through the CFPB's supervisory and enforcement powers.

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[1] CFPB, Data Point: Payday Lending 4 (2014) is available at

http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf.

[2] For loans made under either of these two alternatives, a lender is prohibited from imposing a prepayment penalty. Additionally, if the lender holds consumer funds on deposit, the lender may not sweep the account to a negative balance, exercise a right of setoff, or close an account in response to consumer delinquency or default.

[3] Some states have these central information repositories with look-up capabilities. Presumably venders such as credit reporting agencies would be incentivized to create a nationwide system.