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CFPB Proposes Framework For Payday, Title and Other Installment Loans

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On June 2, 2016, the Consumer Financial Protection Bureau (the "CFPB" or the "Bureau") released a 1,340-page **Notice of Proposed Rulemaking** on short-term lending (the "Proposal")[1]. Our initial, high-level observations on the Proposal, which we continue to analyze, are set forth below.

The Proposal, among other things, is the first time the CFPB has used its authority to prevent unfair, deceptive or abusive acts or practices ("UDAAP") as a basis for rulemaking. Although it has been characterized as a "payday loan" rule, as discussed more fully below, the Proposal would apply across the short-term consumer lending industry, including payday loans, auto title loans, deposit advance products and certain "high-cost" installment loans and open-end loans. It also would apply to "lenders" – bank, non-bank, and marketplace alike – that make "covered" loans for personal family or household purposes.

The Proposal has four major components:

- Requiring covered lenders to determine if a borrower is able to afford certain loans without resorting to repeat borrowing (the "Full Payment Test");
- Permitting covered lenders to forego a Full Payment Test analysis if they offer loans with specific structural features, such as an alternative "principal payoff option" for loans with a term under 45 days or two other alternative options for longer-term loans;
- Requiring notice to borrowers prior to debiting a consumer bank account and restricting repeat debit attempts; and
- Requiring covered lenders to make use of and report to credit reporting systems.

Comments on the Proposal are due by September 14, 2016. Given its potential impact, the Proposal is expected to provoke substantial industry comment. The CFPB's likely timetable for finalizing any rule as well as delay that might arise given the potential for continued political efforts focused on this rulemaking suggest that any final rule would not take effect for some time, perhaps in 2019, at the earliest.[2]

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The Proposal

The CFPB issued the Proposal primarily pursuant to its authority under section 1031 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 to identify and prevent UDAAPs.[3] As such, the Proposal would deem certain loans and practices "abusive and unfair" and would subject lenders engaging in such practices to enforcement action by the CFPB.[4] Importantly, because Congress did not grant the CFPB authority to set a ceiling on interest rates, the Proposal does not include any interest rate caps. Instead, the CFPB seeks to establish such caps indirectly by placing onerous requirements only on those lenders making loans above certain interest rates.

To support the Proposal, the CFPB simultaneously issued a detailed report on the payday loan industry supplementing its prior research on the subject from 2013 through 2016.

Scope and Coverage

The Proposal would apply to a "lender," defined broadly (and generally consistent with the concepts in Regulation Z)[5] to include any person who regularly extends loans to a consumer primarily for personal, family, or household purposes.[6]

The Proposal would cover lenders who make two types of covered loans, either "covered short-term loans" or "covered longer-term loans":

- A "covered short-term loan" includes loans with terms of 45 days or less.[7]
- A "covered longer-term loan" includes all other loans with the "total cost of credit" above 36% per annum that also either take collateral in the borrower's vehicle or utilize a "leveraged payment mechanism."[8] The "total cost of credit" refers to an all-in annual percentage rate (APR), which is calculated to include interest as well as charges for credit insurance, charges for ancillary products, finance charges under Regulation Z, application fees, and any fee for participation in any plan or any arrangement for a covered loan.[9] The "leveraged payment mechanism" refers to a lender's right to initiate a money transfer from a consumer's account or to receive payment directly from a consumer's employer or payroll deduction.[10]

The Proposal does not cover certain purchase money security interest loans, real estate secured credit, credit cards, student loans, non-recourse pawn loans, and overdraft services and lines of credit.[11]

Summary of Key Provisions

As noted above, the Proposal would require lenders making covered loans either to engage in a Full Payment Test prior to making a covered loan or to make an alternative loan with certain structural features in lieu of applying the Full Payment Test. In addition, the Proposal contains provisions involving required reporting to credit bureaus and penalty fee prevention.

- **Full Payment Test and Verification.** The Full Payment Test would require lenders to determine if borrowers will have enough income to repay a loan while meeting major financial obligations (i.e., rent) and paying basic living expenses (i.e., food and utilities). Lenders would have to verify income and check a consumer's credit report to verify outstanding covered loans and payments.[12]
- **Balloon Payments.** For short-term loans and installment loans with a balloon payment, borrowers would have to pass the Full Payment Test for the entire duration of the loan or 30 days after the loan's highest payment.[13] Lenders making loans without a balloon payment would only have to test for borrower payment ability during the term of the loan.[14]
- **Justification for Additional Loans.** Lenders would only be able to rollover an existing short-term loan into a second or third similar loan if they are able to show the borrower's financial situation would be materially improved after the new loan.[15] After three consecutive short-term loans, lenders would have to wait for 30 days to make such a new loan.[16] For payday installment or auto title installment

loans, lenders would have to make a similar showing of material improvement and could only offer to refinance if it would result in substantially smaller payments or a substantially lower total cost of credit.[17]

- **Alternative for Short-Term Loans: Principal Payoff Option.** A lender would be able to offer a borrower a Principal Payoff loan up to $500 to be repaid in a single repayment or up to two extensions in which the principal would be steadily reduced.[18] A lender providing this loan would not have to make a Full Payment Test analysis, but would be required to make certain disclosures and would not be permitted to offer this product to higher-risk consumers.[19]

- **Alternatives for Longer-Term Loans.** A lender making longer-term loans would be able to make two types of loans that do not require a Full Payment Test analysis. Option one would be to make loans under the parameters of the National Credit Union Administration's "payday alternative loans" program, with interest rates capped at 28% and an application fee up to $20.[20] Option two would be to offer loans with nearly equal payments with terms up to two years with an all-in cost of 36% or less (excluding a reasonable origination fee) so long as the projected default rate of such loans was 5% or less.[21] If the actual default rate were to exceed 5%, the lender would have to refund the origination fee to borrowers.[22]

- **Reporting Requirements.** Lenders would have to report basic loan information regarding loans made under the Full Payment Test or utilizing the Principal Payoff option to consumer reporting companies.[23]

- **Penalty Fee Prevention.** Lenders would be required to give borrowers written notice (generally three days) before a withdrawal attempt.[24] The notice would provide details such as timing, amount, and payment channel.[25] After two unsuccessful collection attempts, lenders would have to obtain new and specific borrower authorization before attempting additional debits.[26]

Additional Request for Information

In conjunction with the Proposal, the CFPB issued a Request for Information ("RFI") on products and practices not covered by the Proposal. These include high-cost longer-term installment loans and open-end lines of credit that do not require bank account access or take a vehicle as collateral. The RFI also seeks information on practices related to debt collection, sales and marketing of add-on products, loan churning, default interest and teaser rates, and prepayment and late-payment penalties. Responses to the RFI are due October 14, 2016.

Industry Impact

The Bureau appears focused on reducing the number of repeat loans made to borrowers with the highest risk of default.[27] According to the Bureau, these borrowers face increased potential for penalty fees, repeat borrowing, aggressive debt collection, auto seizure, and borrower bank account closure. By requiring covered lenders to assess a borrower's ability to afford a covered loan and to otherwise abide by penalty fee prevention rules, the CFPB aims to reduce the incidence of so-called "debt traps." The CFPB defines this to include failure to underwrite for affordable payments, repeatedly rolling over or refinancing loans, and costly withdrawal attempts by lenders.[28]

A particularly significant aspect of the Proposal is that, although it seeks to protect consumers from bad actors in the specified markets, it also threatens to increase the compliance burden and costs on covered lenders who provide essential access to credit in underserved communities.

Compliance Costs

The Proposal could increase the per-loan cost of compliance in several ways. Given that many lenders do not have an existing compliance infrastructure for verification, reporting or disclosures, they will be forced either to build or outsource such functions. These lenders would have to incur costs related to training employees and building or outsourcing specialized compliance infrastructures. If a lender did not want to comply with the covered loan requirements of the Proposal, then it would have two options: (1) offer an alternative loan that would presumably have a lower interest rate or (2) change its business model such that it no longer has access to a consumer’s bank account or does not take a vehicle as collateral. Certainly, it is expected that these changes would increase loan costs and, consequently, reduce the overall profitability of covered loans for many affected lenders.

Market Dynamics

The Proposal’s requirements, including its compliance burden, could reshape the dynamics of the short-term lending market.

For example, banks have an existing compliance infrastructure and economies of scale that should permit them to offer covered loans pursuant to a lower cost structure than their non-bank competitors. However, despite these relative advantages, many banks likely will remain concerned that the coupling of the Proposal’s underwriting standards for covered loans and the associated compliance costs would, nevertheless, still render the profit margin associated with offering covered loans unattractive. As such, banks will want to consider carefully whether to play a lead role in commenting on the real possibility of the Proposal resulting in reduced lending in the space and suggesting to the Bureau a profitable path to avoiding this outcome by offering additional options and/or permissible alternative loans. Banks also may seek to explore product offerings that fit within the strictly-defined alternatives, especially because those loans do not require enhanced underwriting or a new compliance infrastructure.

Another important consideration is that marketplace lenders and other FinTech firms operating in the retail lending space may be able to leverage their technological knowledge to create more efficient, cost-effective compliance solutions. For example, such lenders are well-positioned to leverage big data analytics to provide reliable housing cost estimates for a borrower’s locality, as permitted by the Proposal.[29] These companies can also offer platforms to help lenders quickly connect to a borrower’s bank statement to verify income through a “reliable record” of income payment, which can be a record of “depository account transactions.”[30] Companies with these technological approaches could either offer covered loan products themselves pursuant to a lower cost structure or could offer to outsource compliance services to smaller businesses most impacted by the Proposal. Banks with existing FinTech incubator programs may also seek to foster the development of such technologies.

Lenders may also seek to tailor their business model to focus on lower-risk borrowers in an effort to avoid the Proposal’s requirements. For instance, a lender making a longer-term loan exceeding a 36% interest rate may seek to avoid the requirements of the Proposal by foregoing the ability to take funds from a borrower’s account and not taking a vehicle as collateral. Such a lender could still monitor, in real time, the funds within a borrower’s account to continually assess the risk of non-payment and receive alerts when borrower funds drop below a certain amount.

Issues for Industry Comment

During the comment period, industry participants may wish to respond to several important aspects of the Proposal:

- **Cost Issues.** Banks, nonbank lenders and other industry participants, including providers of capital to the industry (collectively, “Industry Participants”), may seek to counter the Bureau’s section 1022(b)(2) analysis of potential benefits and costs. Important considerations are how much it will cost to: (i) perform an ability-to-repay determination, (ii) provide notice to consumers, (iii) update compliance management systems, and (iv) train employees. Lenders may also seek to comment on the relative cost and profitability compared to making loans under the Proposal’s alternative loan requirements. In addition, many lenders would have to create a potentially costly system specific to furnishing loan information to credit reporting agencies. Lenders may also focus on how increased costs may require larger origination fees to recoup origination costs and the potential effect of that increase on consumer access to credit.

- **Verification Issues.** Industry Participants may also seek to persuade the Bureau of the difficulties and impracticality of verifying “major financial obligations” of borrowers, such as rent payments (for customers who share rental payments) or child support obligations. Similarly, Industry Participants may seek to address the initial difficulties in obtaining reliable information on a borrower’s borrowing history for other covered loans, because consumer reports currently do not indicate what is and is not a covered loan.

- **Access to Credit.** The comments of Industry Participants (and perhaps even some consumer groups) could focus on increased compliance costs that could force smaller businesses with already-thin profit margins to cease lending or to reduce loan volumes. Such lenders could seek to share experiences of borrowers who accessed short-term credit without entering into a “debt trap.” A strong point of reference is a Federal Reserve 2014 report indicating that many Americans would have to borrow funds to pay an emergency expense of $400 or more, underscoring the critical importance of short-term, small dollar lending for many consumers. Another important point is the likelihood that borrowers with reduced access to credit would have to incur overdraft fees (not covered by the proposed rule) or seek other alternative (e.g., offshore) lenders.

- **Use of All-in APR.** Another important issue is that certain other federal lending regulations (e.g., Regulation Z) do not require calculation of APR on an “all-in” APR basis (defined above to include interest as well as charges for credit insurance, ancillary products, Regulation Z finance charges, application fees, and fees for participation in any plan or any arrangement for a covered loan). Industry Participants may find it worthwhile to seek standardization for calculation of APRs to avoid the expense of programming a new calculation and related costs.

- **Definition of “Reasonable.”** Finally, Industry Participants may want to seek specific examples or further clarification of what constitutes a “reasonable” determination of ability to repay under the Proposal. The Proposal provides currently that a covered lender’s ability to repay analysis must, at a minimum, (i) verify income, housing expenses, and debt obligations using a national consumer reporting system, (ii) forecast reasonable estimates of basic living expenses, (iii) project income, debt obligations, and housing costs, (iv) make reasonable inferences and conclusions regarding a borrower’s ability to repay, and (v) appropriately account for information known by the lender,[31] but it provides no safe harbor for covered lenders. The absence of a safe harbor leaves open the possibility that the decisions of covered lenders might still be subject to scrutiny on the grounds that they are not “reasonable” even if those lenders analyze all the requisite information in the Proposal. This risk seems particularly acute given that the Proposal does not provide examples of what it means to create “reasonable estimates” of basic living expenses, what constitutes “reasonable inferences and conclusions” regarding a borrower’s ability to repay, or what it means to “appropriately account” for information known by the lender.[32]

Next Steps

- Lenders subject to – and other Industry Participants potentially impacted by – the Proposal should consider commenting on the Proposal (by September 14, 2016) and/or the RFI (by October 14, 2016), as appropriate.

- Because of the breadth of the Proposal, lenders offering consumer lending products and services beyond those explicitly excluded, and other Industry Participants, should carefully examine the Proposal to determine whether it could apply to their business or business operations/interests.

- Industry Participants should also be reviewing technological solutions and alternative product structures that may become important to comply with and otherwise navigate the Proposal’s requirements, should the Proposal be finalized as proposed.

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[1] Prior to issuing the Proposal, in March 2015, the CFPB released a preliminary framework for payday lending for purposes of convening a panel of small entity representatives to solicit information on the impact the rule would have on small businesses and to recommend regulatory alternatives pursuant to the Small Business Regulatory Enforcement Fairness Act of 1996 ("SBREFA"). The SBREFA panel met in April 2016 and the CFPB's June 2015 report detailed the panel's recommendations to the preliminary framework. Although the Proposal has retained some features of the CFPB's SBREFA outline, it differs in material respects. For instance, the Proposal does not contain an alternative that would have permitted lenders to make loans less than 5% of a borrower's gross monthly income without undertaking a Full Payment Test. It also contains a more detailed definition of "all-in" APR. The CFPB has not offered any reasons for the modifications and it is not clear what prompted the changes.

[2] In previous substantive rulemakings, the CFPB has generally spent over a year reviewing comments and finalizing a rule. For example, the comment period for the Prepaid Accounts under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z) Proposed Rule closed on March 23, 2015 and, to date, the CFPB has not finalized the rule. Under a similar timeframe, a final rule in this space would not be published until 2018. According to the Proposal, a final rule would become effective 15 months after its publication in the Federal Register. This brings us to an effective date in 2019.

[3] 12 U.S.C. § 5531. The Bureau also issued the proposed rule pursuant to sections 1022 (authority to prescribe rules and make exemptions from such rules as is necessary or appropriate to carry out the purposes and objectives of the federal consumer financial laws), 1024 (authority to facilitate supervision of certain nonbank financial service providers), and 1032 (authority to prescribe rules to ensure effective consumer disclosures)

[4] Proposal Sections 1041.4, 1041.8 and 1041.13. The Proposal uses the terms "abusive and unfair" and "unfair and abusive." Compare Proposal Section 1014.13(a) to Proposal Section 1014.8(a).

[5] *See generally*, 12 C.F.R. § 1026.1(c), but noting, however, that Regulation Z requires a minimum of four installment payments to trigger coverage under the Truth in Lending Act.

[6] Proposal Section 1041.2(11).

[7] Proposal Section 1041.3(b)(1).

[8] Proposal Section 1041.3(b)(2).

[9] Proposal Section 1041.2(18)(iii).

[10] Proposal Section 1041.3(c).

[11] Proposal Section 1041.3(e).

[12] Proposal Sections 1041.5 and 1041.9.

[13] Proposal Sections 1041.7 and 1041.10.

[14] Proposal Section 1041.10.

[15] Proposal Section 1041.6.

[16] Proposal Section 1041.6.

[17] Proposal Section 1041.10.

[18] Proposal Section 1041.7.

[19] Proposal Section 1041.7.

[20] Proposal Section 1041.11.

[21] Proposal Section 1041.12.

[22] Proposal Section 1041.12.

[23] Proposal Section 1041.16.

[24] Proposal Section 1041.15.

[25] Proposal Section 1041.15.

[26] Proposal Section 1041.14.

[27] *See generally*, Proposal Background.

[28] CFPB Press Release March 26, 2015.

[29] Proposal Section 1041.5(c)(3)(ii)(D)(2).

[30] Official Interpretations to Proposal Section 1041.9(c)(3)(ii)(A).

[31] Official Interpretation to Proposal Section 1041.5(b).

[32] *See* Official Interpretation to Proposal Section 1041.5(b).