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A Closer Look at the CFPB's Proposed Short-Term Lending Rule

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As we previously reported in our June 3, 2016 client alert, the Consumer Financial Protection Bureau ("CFPB") has issued a Notice of Proposed Rulemaking for short-term loans ("Proposed Rule"). In this follow-up alert, we take a closer look at the Proposed Rule and its implications for consumer lending generally. Comments on the Proposed Rule are due by September 14, 2016.

The CFPB simultaneously issued a Request for Information ("RFI") on other potentially high-risk loan products and practices not specifically covered by the Proposed Rule. Comments on the RFI are due by October 14, 2016.

There are five major components to the Proposed Rule:

1. It would be an abusive and unfair practice to make a covered loan unless the consumer has the ability to repay the loan or the loan meets the requirements necessary to be considered conditionally exempt from the ability-to-repay determination;

2. The ability-to-repay determination would require lenders to both collect a substantial amount of information from the consumer and verify the collected information with evidence obtained from third parties;

3. In certain situations, borrowers would be presumed to have an inability to repay a loan, and in several instances lenders would be altogether prohibited from making a covered loan;

4. If a lender has initiated two consecutive failed payment transfers on a covered loan, the lender would be prohibited from initiating another payment transfer unless the lender provides disclosures and obtains additional authorization from the consumer; and

5. Lenders making covered loans would need to furnish information regarding the covered loans to either a consumer reporting agency or a so-called "registered information system."

Parts of the Proposed Rule, such as the so-called "conditionally exempt" provisions are extraordinarily complex and, if retained in the final rule, will likely be unworkable and so burdensome that lenders will not use those provisions.

SCOPE OF THE PROPOSED RULE

Although the Proposed Rule is often characterized as a "payday loan rule," the rule is sweeping in terms of the products covered and the limitations it would impose. Broadly speaking, the Proposed Rule would apply to any lender that makes covered closed-end or open-end consumer loans. Under the Proposed Rule, covered loans are classified as either short-term or longer-term. There are, however, several types of loans that would be exempt from the Proposed Rule.

Covered short-term loans are defined as loans with contractual durations of 45 days or less. This would include, for example, loans with a single payment, short-term vehicle title loans and open-end credit lines where substantial repayment of an advance is due within 45 days of the advance.

Longer-term loans are loans with a duration of more than 45 days that have (1) a total cost of credit ("TCC") in excess of 36 percent, and (2) either take a security interest in a consumer's vehicle or have a "leveraged payment mechanism" that provides the lender with a right to collect payments from the consumer's account or to obtain payments via payroll deduction or other direct access to the consumer's source of income; however, loans to purchase a vehicle where the lender takes a security interest in the vehicle are completely exempt from the Proposed Rule, even if the loan would otherwise be a covered loan. Proposed commentary to the Proposed Rule provides that a "leveraged payment mechanism" would include a lender obtaining payment via a check from the consumer or via certain types of recurring electronic fund transfers. The coverage of paper checks in this definition may result in the coverage of many "traditional" installment loans. The Proposed Rule also refers to longer-term balloon-payment loans as a subset of longer-term loans. A longer-term balloon-payment loan is a loan that meets the above definition of a longer-term loan, but additionally, requires the consumer to repay the loan in a single payment or make at least one payment that is more than twice as large as any other payment under the loan.

The definition of longer-term loans would establish a new rate calculation figure—the TCC—that includes more charges than the ones that must be included in the annual percentage rate ("APR"). The TCC calculation includes not only finance charges as defined in Regulation Z, but fees incurred within 72 hours after the loan is made in connection with credit insurance, credit-related ancillary products, services, or membership such as identity theft protection, application fees, and any fees for participation in a plan or arrangement. Under the Proposed Rule, a lender making loans with terms longer than 45 days would need to compute the TCC to determine whether the loan is a covered longer-term loan. In this regard, the Proposed Rule is similar to the Department of Defense ("DOD") Military Lending Act ("MLA") regulation, in that it requires non-standard cost-of-credit calculations. Indeed, the TCC calculation under the Proposed Rule is substantially similar to the "Military APR" calculation set forth in that rule. Unlike the DOD MLA rule, however, which prohibits making a loan with a Military APR greater than 36 percent, the CFPB's Proposed Rule would use the new TCC as a threshold for coverage.

Because the TCC is calculated differently from the APR, lenders that take a security interest in a consumer's vehicle *or* that have 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 source of income would need to calculate the TCC to determine whether the loan is covered. Because several fees must be included in the TCC which are not part of the APR calculation, a loan with a relatively low APR may nonetheless have a TCC greater than 36 percent, particularly if the loan has a short duration or a small loan amount.

The Proposed Rule would exempt (1) purchase money security interest loans, such as loans to purchase a car or personal property secured by the subject of the purchase; (2) credit secured by any real property; (3) credit cards; (4) student loans; (5) non-recourse pawn loans; and (6) overdraft services and overdraft lines of credit.

COMPLIANCE

The Proposed Rule articulates a primary method of compliance involving an ability-to-repay determination, but also provides alternative models of compliance for covered loans in lieu of satisfying the ability-to-repay requirements. Therefore, a lender making a covered loan (either short-term or longer-term) could comply by either satisfying the ability-to-repay provisions or meeting another specified test. The CFPB described loans meeting these alternative tests as "conditionally exempt" loans. However, the requirements for so-called conditionally exempt loans are extremely complex, and, therefore, it is doubtful any lender would satisfy or choose to rely on these tests. Under the Proposed Rule, it would be an unfair and abusive practice for a lender to make a covered loan that does not satisfy either the ability-to-repay test or meet a conditional exemption. It is worth noting, however, that the conditional exemptions do not apply to open-end credit, and, therefore, a covered open-end line of credit could only comply with the Proposed Rule if it meets the ability-to-repay test.

ABILITY TO REPAY LOANS

The ability-to-repay rules are, in most respects, the same for both short-term and longer-term loans. Unless a covered loan meets one of the conditional exemptions (discussed further below), it would be an unfair and abusive practice for a lender to make a covered loan unless the lender makes a reasonable determination that the consumer has an ability to repay the loan.

For all covered loans, a determination of ability to repay is reasonable only if the consumer's residual income is sufficient to make all covered loan payments and meet basic living expenses during the term of the loan. "Residual income" is defined as the consumer's net income during the loan period, minus amounts payable by the consumer for major financial obligations during the period, as projected by the lender. Additionally, for short-term loans and longer-term loans with balloon payments (i.e., all covered loans except longer-term loans without balloon payments), a lender also must conclude that the consumer will be able to (1) make payments for major financial obligations; (2) make remaining payments on the covered loan; and (3) meet basic living expenses for 30 days after making the highest payment for the covered loan.

The ability-to-repay determination must be based on a lender's reasonable projection of the amount and timing of net income and payments for "major financial obligations," a term which is defined to include housing expenses, child-support obligations, and amounts due on other debt obligations. The lender's projections on net income and financial obligations must be based on written information from the consumer and verified using evidence obtained from the records of the lender and its affiliates, a consumer report from a nationwide consumer reporting agency, and a consumer report from a registered information system.

The amount of information that must be collected and verified under the ability-to-repay model is significant. The Proposed Rule would require more information to be considered and verified for covered loans than is required under the ability-to-pay rules adopted for credit cards and mortgages.

PRESUMPTIONS OF INABILITY TO REPAY

Moreover, the Proposed Rule enumerates a number of situations in which the lender must presume that a consumer is unable to repay a covered loan, even if the consumer would otherwise meet the ability-to-repay test. Prior to making any ability-to-repay loan, a lender would be required to review the consumer's borrowing history by reviewing the records of the lender and its affiliates, a consumer report from a nationwide consumer reporting agency, as well as a consumer report obtained from a registered information system (discussed further below) in order to determine if a presumptive inability to repay applies. Where a presumptive inability to repay applies, the presumption could be overcome only if a lender determines that the consumer will have sufficient improvement in financial capacity such that the consumer will have the ability to repay the loan. The Proposed Rule provides general guidance on how this determination should be made; however, no safe harbor exists. Thus, it may be risky for lenders to conclude that a presumption of inability to repay has been rebutted.

There are three presumptions of inability to repay that may apply.

1. *Consumer has had a short-term loan outstanding in the last 30 days.* First, there would be a presumptive inability to repay if the consumer has had a short-term loan outstanding within the last 30 days. Depending on whether the new loan being made is a short-term loan or a longer-term loan, certain exceptions to this presumption may apply. For example, if the new loan is a short-term loan, there is no presumptive inability to repay if the earlier loan has been fully paid or is rolling over. If the new loan is a longer-term loan, the presumptive inability to repay would not apply if every payment on the new longer-term loan is substantially smaller than the largest required payment on the prior loan. Where an exemption applies, a lender would not have to rebut a presumptive inability to repay, but must only demonstrate that the borrower satisfies the ability-to-repay requirements.

2. *Consumer has had a longer-term balloon-payment loan outstanding in the last 30 days.* Second, there would be a presumptive inability to repay if the consumer has had a longer-term balloon-payment loan outstanding within the last 30 days. As was the case with the first presumption, if the new loan is a longer-term loan, the presumption of inability to repay would not apply as long as every payment on the new longer-term loan is substantially smaller than the largest required payment on the prior balloon-payment loan.

3. *Consumer has had an outstanding loan with an indicator of unaffordability.* Third, there would be a presumptive inability to repay if the consumer has a covered or non-covered loan outstanding that was made or serviced by the lender or its affiliate and at least one of the following is present:

    - The consumer is or has been delinquent on such a loan by more than seven days in the last 30 days;
    - The consumer has expressed an inability to make payments within the past 30 days, for example, by requesting additional time to make a payment;
    - The period of time between consummation of the new loan and the first scheduled payment would be longer than the period of time between consummation of the new loan and the next payment on the outstanding loan; or
    - The new loan would result in the consumer receiving no disbursement of loan proceeds or an amount of disbursement that would not substantially exceed the amount that would be due on the outstanding loan within 30 days of the new loan.

    For longer-term loans only, this third presumption of inability to repay does not apply if either:

    - The size of every payment on the new loan would be substantially smaller than the size of every payment on outstanding loan; or
    - The new loan would result in a substantial reduction in the TCC relative to the outstanding loan.

PROHIBITIONS

The Proposed Rule also enumerates certain scenarios where lenders would be prohibited from making covered loans under the ability-to-repay approach. Prior to making an ability-to-repay loan, a lender is required to review the records of the lender and its affiliates, a consumer report from a nationwide consumer reporting agency, as well as a consumer report obtained from a registered information system in order to determine whether a prohibition applies. These prohibitions would not, however, apply to lenders making covered loans using the conditionally exempt method.

Lenders would be prohibited from making a short-term ability-to-repay loan if the borrower has had a conditionally exempt short-term loan—made by any lender—outstanding in the last 30 days.

Additionally, lenders would be prohibited from making a short-term ability-to-repay loan if the loan would be the fourth loan in a sequence of short-term ability-to-repay loans that the consumer has received from any lender. A loan is part of a sequence of loans if the loan is made while the consumer currently has an outstanding covered short-term loan or if the loan is made within 30 days of when a previous loan was outstanding.

Finally, lenders are prohibited from making ability-to-repay longer-term loans if the consumer has a conditionally exempt short-term loan made by the lender or its affiliate that was outstanding within the last 30 days.

CONDITIONALLY EXEMPT LOANS

As an alternative to the ability-to-repay method, lenders could make covered loans that meet the requirements to be considered conditionally exempt loans.

SHORT-TERM LOANS

To be a conditionally exempt short-term loan, the terms of the loan would be required to satisfy the structural requirements specified in the Proposed Rule, including:

- The loan must be a closed-end loan;
- The lender must not take a security interest in the consumer's vehicle in connection with the loan;
- If the consumer has not had a covered conditionally exempt short-term loan outstanding within the previous 30 days, then the initial principal amount must be no greater than $500, and each successive conditionally exempt short-term loan made within 30 days of an earlier conditionally exempt short-term loan must have at least a one-third reduction in the principal owed, as compared to the initial loan;
- The loan must not be the fourth loan in a sequence of conditionally exempt short-term loans made by the lender (or its affiliate); and
- The loan must completely amortize during the term of the loan.

If the loan meets the structural requirements, the lender also would have to verify the consumer's borrowing history, including confirming that the consumer does not have a short-term loan or an ability-to-repay longer-term loan outstanding with any other lender. Similarly, the lender would be required to 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. In addition, a lender making conditionally exempt short-term loans must provide certain disclosures to the consumer before the first or third loan in a sequence is consummated.

LONGER-TERM LOANS

For longer-term loans, a lender would have two alternative ways of making a conditionally exempt loan. For each type of conditionally exempt longer-term loan, additional requirements would apply. There are several requirements that would be applicable for both types of conditionally exempt longer-term loans. For example, the loans must be closed-end loans, and a lender is prohibited from imposing a prepayment penalty. Additionally, if the consumer has a deposit account with the lender, the lender may not sweep the account to a negative balance, exercise a right of set-off, or close an account in response to consumer delinquency or default. Furthermore, a lender must furnish loan information either to each registered information system (as explained further below) or to a nationwide consumer reporting agency at the earlier of the next regularly scheduled time information is furnished or within 30 days of consummation of the loan. Covered loans made under these conditional exemptions also would have to be repayable in two or more payments that are substantially equal in amount, meaning that the conditional exemptions are not available for longer-term balloon-payment loans.

NCUA Payday Alternative Loans

Under the first alternative, a lender could offer closed-end longer-term loans that are modeled on the National Credit Union Administration (“NCUA”) 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 a TCC that is more than the cost that federal credit unions may charge under the PAL regulations. Currently, the PAL regulations permit an interest rate of 28 percent and an application fee of no more than $20, and prohibit other fees (it is not clear from the Proposed Rule how a lender would compare the TCC, which includes fees, to the NCUA interest rate). Before making a conditionally exempt loan of this type, the lender would be required to determine from its records and the records of any affiliates that the loan will not result in the consumer being indebted on more than three conditionally exempt loans of this type from the lender and/or its affiliates within a period of 180 days.

Loans Resulting in Annual Portfolio Default Rate of Five Percent or Less

Under the second alternative, a longer-term loan could be conditionally exempt from the ability-to-repay requirement if the longer-term loan meets proposed structural conditions. Specifically, a longer-term loan must 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 have a TCC of no more than 36 percent, 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 loan. Because a loan is only a covered longer-term loan if the TCC exceeds 36 percent, this conditional exemption would apply only to a very narrow class of loans in which the origination fee pushes the TCC over 36 percent. Before making a loan under this conditional exemption, a lender would have to determine from its records and the records of any affiliates that the loan will not result in the consumer being indebted on more than two conditionally exempt loans of this type from the lender and its affiliates within a period of 180 days.

For a lender making loans under this conditional exemption, the lender would be required to use an underwriting approach that results in an annual default rate of five percent or less on the portfolio of loans made pursuant to this conditional exemption. It remains to be seen whether lenders would be able to create a portfolio of loans with a default rate of five percent or less. This second option for making conditionally exempt longer-term loans is a departure from the CFPB’s March 2015 outline of proposals, which had suggested the CFPB’s proposal would provide a conditional exemption for loans structured with a payment-to-income ("PTI") ratio of less than five 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 is particularly noticeable. However, the CFPB specifically requests comment on whether a maximum PTI approach should be available.

GENERALLY APPLICABLE REQUIREMENTS

In addition to the requirements listed above, the Proposed Rule would impose a number of requirements that apply broadly to lenders that make covered loans.

Payment Collection Activities

The Proposed Rule specifically seeks to address the CFPB's concern that some consumers incur substantial costs when a lender makes repeated unsuccessful attempts to collect payments on a loan. Specifically, because an institution that holds a consumer's deposit account may impose a non-sufficient funds fee for each attempt, the consumer may incur unanticipated fees in connection with the loan. To prevent the imposition of multiple fees for unsuccessful collection attempts, the Proposed Rule specifies that after a lender has initiated two consecutive failed payment transfers in connection with a covered loan, the lender would not be allowed to initiate another payment transfer unless the consumer authorizes the payment transfer or requests a single immediate payment transfer.

In the event that a lender initiates two consecutive failed payment transfers, the lender would have to provide the consumer with a notice informing the consumer that the last two attempts to withdraw payment were unsuccessful and setting forth information about the attempts, including the date and amount of the attempts and any fees charged by the lender as a result of the unsuccessful attempts.

Additionally, prior to initiating any payment transfer from a consumer's account, the lender would be required to provide the consumer with a payment notice alerting the consumer to the timing, amount, and payment method of the upcoming transfer. A payment notice would not, however, be required for:

- A payment transfer in connection with a conditionally exempt longer-term loan;
- The first payment transfer from an account after obtaining consumer consent; or
- A single immediate payment transfer initiated at the consumer's request.

Information Furnishing

As noted above, if a lender is making conditionally exempt longer-term loans, the lender must furnish the loan information either to each registered information system or to a nationwide consumer reporting agency. For all other covered loans, a lender would be required to furnish loan information to each registered information system. Under the Proposed Rule, a registered information system would be a consumer reporting agency that registers with the CFPB and is deemed by the CFPB to be competent to receive and report information on covered loans, as well as to maintain a compliance management program and meet certain data security protocols. Registered information systems would be consumer reporting agencies under the Fair Credit Reporting Act ("FCRA"), and, as such, all requirements for furnishers under the FCRA would be applicable to lenders making covered loans.

Compliance Program

The Proposed Rule would specifically require that lenders making covered loans 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 likely impose significant costs and burdens on lenders.

Liability and Private Rights of Action

The CFPB issued the Proposed Rule pursuant to Section 1031 of the Consumer Financial Protection Act of 2010 (“Act”), which grants authority to the CFPB to prescribe rules “identifying as unlawful unfair, deceptive, or abusive acts or practices [(“UDAAP”)] in connection with any transaction with a consumer for a consumer financial product or service.”[1] This is the first time the CFPB has used its UDAAP authority for rulemaking purposes. The Act does not grant a private right of action for any violation of a rule promulgated under this provision, nor does the Proposed Rule suggest one exists. However, lenders should be mindful of state consumer credit laws, some of which may provide 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 be able to assert that a violation of the federal rule is actionable under state law.

TAKEAWAY POINTS

The Proposed Rule is complex and is largely unprecedented. Below are some key takeaway points on the effects of the Proposed Rule.

- Notwithstanding several major exclusions from the rule’s coverage (i.e., credit cards, student loans, and mortgages), the Proposed Rule is broad enough that lenders will want to examine the Proposed Rule to see how it may apply to their consumer lending business.
- The Proposed Rule could limit consumer access to short-term lending products and services and perhaps to traditional installment loans.
- Although the ability-to-repay determination imposes substantial underwriting requirements, the alternative conditional exemptions are so complex they likely will not offer true options for lenders to use.
- The Proposed Rule will require lenders making covered loans to access and furnish information to consumer reporting agencies, which is a substantial undertaking that requires compliance with federal and state credit reporting laws.
- Many of the requirements in the Proposed Rule require lenders to make “reasonable” determinations. Although the Proposed Rule provides some guidance on when a determination is “reasonable,” the term is inherently ambiguous, leaving lenders exposed to regulatory uncertainty, which may result in CFPB or other agency supervisory or enforcement actions.

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[1] 12 U.S.C. § 5531(b).

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