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CFPB Seeks to Expand Its Dominion Over Consumer Lending with Strict Proposed Rules

On June 2, 2016, the Consumer Financial Protection Bureau (CFPB) released a long-anticipated proposal pursuant to its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act to regulate the provision and collection of certain short-term, small-dollar credit products, including payday and vehicle title loans, as well as certain longer-term high-rate installment and open-end loans. The proposal follows an outline of the bureau's rulemaking plans floated in March 2015 as part of the consultation process prescribed in the Small Business Regulatory Enforcement Fairness Act ("SBREFA Outline").

At the highest level, the proposal is aimed at regulating two general sets of products. The first are short-term credit products that require consumers to pay back the loan in full within 45 days or less, such as payday loans, deposit advance products, certain open-end lines of credit and some vehicle title loans, and the second are longer-term credit products for which the lender obtains a nonpurchase money lien on a consumer's vehicle or right to collect repayment from the consumer's account or paycheck through a payment authorization from the consumer ("covered loans"). The CFPB refers to these products broadly as "liquidity loans," reflecting their most common use by consumers to address a short-term cash crunch.

The CFPB's proposal would generally oblige lenders either to determine whether a consumer has the ability to repay a loan, or alternatively, to adhere to certain requirements governing the terms of the loan. The proposal would also require lenders to follow a set of guidelines when attempting to collect loan repayments. Lenders covered by the rule include nonbank entities as well as banks and credit unions.

The proposal, which stretches some 1,334 pages, includes 1,077 footnotes and is the culmination of years of market study by the bureau, is now open to public comment until September 14, 2016, and the CFPB has highlighted certain aspects of the proposal for which it seeks input. In addition to the proposal, the CFPB concurrently released a request for information seeking feedback on "risky" products and practices not covered by the proposal. Alston & Bird is prepared to assist clients with understanding the proposal and with providing comments to the CFPB.

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Observations

Despite the CFPB's efforts to ensure transparency and to engage in extensive data gathering and analysis, the rules derive primarily from a determination by the CFPB (subject to comment) that covered loans are *per se* "abusive and unfair" if the lender does not make a determination of the borrower's ability to repay.

Another fundamental premise underlying the proposal is that instead of addressing perceived unfair, deceptive or abusive acts and practices by means of its supervision and enforcement powers, the CFPB believes a new federal regulation is warranted. However, no matter how carefully considered, any rulemaking proposal that requires over 1,300 pages to articulate is likely to have unintended consequences.

While providing a degree of clarity on the CFPB's perspectives to the market, the proposal risks hindering nascent innovation in the market from FinTech companies, banks and other traditional lenders that would allow for the development of alternative products and services that could drive credit prices down and ensure the best protection for consumers.

The proposal dropped an important exemption telegraphed in the SBREFA Outline. Namely, a structural exemption from the ability-to-repay requirements for longer-term covered loans where loan payments are limited to 5 percent of the borrower's gross income for the same period and the loan meets other structural requirements.

The proposal *reduced* the SBREFA Outline proposal for the mandatory cooling-off period following a third loan in a sequence from 60 days to 30 days.

The proposal provides a "safe harbor" from the ability-to-repay and notice requirements for lenders that mimic the National Credit Union Administration's payday alternative loan (PAL) structure, which includes interest rate and annual percentage rate (APR) caps.

The proposal defines a new category of regulated entity—the "registered information system." The proposal requires that lenders provide information about their lending to *all* entities that are registered information systems, in compliance with the Fair Credit Reporting Act. Lenders would, in turn, be required to obtain a consumer report from one of these entities before making most covered loans. Registered information systems would be subject to CFPB supervision either under the CFPB's larger participants' rule for consumer reporting agencies or "by consent."

The definition of "lender" under the proposal includes banks and other federally regulated entities. The apparent intent of this inclusion is to ensure a level playing field, but given the CFPB's decision not to provide certain structural exemptions, the proposal may discourage federally supervised banking institutions from competing alongside lightly supervised state-licensed lenders to provide alternative products and drive prices down.

The bureau's concurrent request for information seeks input from the public regarding high-cost installment loans and open-end lines of credit not covered within the proposal, as well as garnishment and collections practices, refinancing practices, prepayment penalties, teaser rates and a range of other consumer lending practices. This development signals the next chapter in the bureau's activity in the small-dollar credit market, potentially covering an even wider swath of the consumer lending industry.

Background

Payday, vehicle title and similar loans are already regulated under a variety of state laws and various tribal and municipal laws. Some jurisdictions have banned these types of consumer loans outright, and others have regulated loan structures and lender practices in a variety of ways, including imposing usury limits, limiting fees, restricting reborrowing in certain circumstances or setting a maximum ratio relative to gross monthly income. States, tribes and local governments also impose a variety of licensure requirements on lenders engaged in small-dollar lending.[1]

Since its inception, the CFPB has been transparent regarding its determination to regulate the small-dollar loan industry. When the CFPB began supervising nondepository institutions in 2012, payday lending and similar products were among the first industries to undergo the bureau's scrutiny. Since 2012, the CFPB has sought input from consumers and testimony from consumer and civil rights groups and industry representatives and conducted studies of the market and data obtained from payday lenders and banks offering small-dollar loans. The CFPB's Supervision and Examination Manual, originally released in 2011, contains examination procedures to ensure payday lenders act in compliance with federal consumer finance laws. The CFPB already actively supervises larger participants in the market and has used its enforcement authority to take action against certain entities.[2]

CFPB Analysis and Considerations Regarding Covered Loans

Since 2012, the CFPB has issued five reports (the latest was issued simultaneously with the proposal) providing the bureau's findings and assessment of the market. These reports drew upon field hearings, meetings with interested parties and information gathered by the CFPB in the exercise of its supervisory and enforcement authority. The proposal is heavily informed by selective use of data and anecdotal information gathered by the CFPB and from other sources.

The CFPB has also reported that its examinations found that a number of payday lenders had not implemented effective compliance management systems, and the bureau expressed concerns about ineffective oversight of third-party service providers, inadequate complaint management, failure to adopt appropriate written policies and procedures, failure to adequately train staff and lack of effective compliance audit programs. The CFPB more recently expressed concern over online lenders' repeated attempts to collect payments from a borrower's account after a failed draft attempt due to insufficient funds, with each attempt potentially resulting in additional fees added to the borrower's balance.

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1 According to the proposal: "[t]here are now 36 States that either have created a carve-out from their general usury cap for payday loans or have no usury caps on consumer loans. The remaining 14 States and the District of Columbia either ban payday loans or have fee or interest rate caps that payday lenders apparently find too low to sustain their business models." Within those states that authorize payday lending, the states' additional restrictions vary, including caps on the number of "rollovers," requirements that the borrower amortize the rollover, restrictions on "back-to-back" loans and "cooling-off" periods, and requiring an offer of extended repayment plans (or additional time) to borrowers who encounter difficulty in repaying payday loans.

2 The Dodd-Frank Act also grants the CFPB authority to take action against a financial services provider in order to prevent unfair, deceptive or abusive acts or practices. The CFPB recently wielded this authority when it filed a complaint against All American Check Cashing, Inc., in May 2016. In the complaint, the CFPB alleged All American made deceptive statements to consumers about the benefits of its payday loans and also failed to provide refunds after consumers made overpayments on their loans. The CFPB's lawsuit seeks to end All American's allegedly unlawful practices, obtain redress for consumers and impose penalties.

In 2014 and 2015, the CFPB also held numerous meetings on consumer lending with consumer advocacy groups; state, municipal and tribal officials;[3] and representatives from industry and trade associations in order to seek input as the bureau was in the process of formulating its proposals. In March 2015, the SBREFA Outline described the proposal under consideration. In conjunction with the release of the proposal on June 2, 2016, the CFPB also issued its fifth study on the small-dollar loan industry. Throughout the period preceding the proposal, it became increasingly clear to the industry that the bureau was biased in favor of product-based regulation, rather than continued use of the substantial supervisory and enforcement tools at its disposal to address problematic practices by certain lenders. The CFPB largely ignored substantial anecdotal evidence from consumers who acknowledged that such lending was often the best, most convenient and cheapest form of credit available to them.

Competing Policy Views

The CFPB's anticipated action, culminating in the proposal, has drawn sharply competing views. According to one study by the Federal Reserve Bank of New York, "except for the ten to twelve million people who use them every year, just about everybody hates payday loans." Supporters of the regulation, such as the National Consumer Law Center, tout the need to protect borrowers from entering into loans they cannot afford to repay, which in turn could lead to a cycle of additional loans and increased fees.

By contrast, others have expressed concern that this regulation will drastically limit the availability of small-dollar credit products to consumers who have limited alternatives to borrow money and are often ineligible for more conventional loans with lower rates. Some have taken issue with the concept of requiring an assessment of ability to repay and the proposed cooling-off period (comparing it to requiring a credit card lender to re-underwrite the holder and to force the holder to have to wait two months before using the card again). Opponents have also noted that the proposal adds cost to lenders that have to re-establish a relationship with the borrower two months later, further undermining the availability of credit.[4]

Independent observers have had mixed views. The analysis published by the Federal Reserve Bank of New York advocates for more research and focuses on a critical lack of evidence of behavioral "cognitive bias" that leads consumers to roll over their loans due to irrational over-optimism of future payment. Notably, the Pew Charitable Trusts, supporters of regulating the industry, has since criticized the proposal after the CFPB *removed* a 5 percent of gross income alternative to the assessment of ability to repay for longer-term covered loans that appeared in the SBREFA Outline, which, according to Pew, will hinder banks from entering the market to offer lower-cost loans to consumers. Still others believe the proposal does not go far enough, arguing that the bureau should not permit any alternatives to the ability-to-repay standard.

The CFPB's activity has also generated bipartisan congressional interest. For example, nine Democrats and 16 Republicans have co-sponsored the Consumer Protection and Choice Act, which provides that if a state

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[3] The CFPB has acknowledged there is a "unique legal relationship" between the federal government and tribal nations that is reflected in the bureau's Tribal Consultation Policy.

[4] *See Berry, "*Four Things to Watch for in the CFPB's Payday Lending Proposal," *American Banker* (May 31, 2016) [subscription req'd] (quoting Dennis Shaul, chief executive officer of the Community Financial Services Association of America and Bill Himpler, executive vice president of legislative affairs at the American Financial Services Association).

has a "deferred presentment transaction" law that satisfies certain requirements set forth in the bill, any CFPB rules regulating payday loans would not apply in that state. Similarly, two members of the House Financial Services Committee have commented on the proposal's effects on tribal sovereignty and state law preemption.[5]

Summary of the Proposal

The CFPB relies primarily upon Section 1031 of the Dodd-Frank Act, which authorizes the CFPB to issue rules designed to prevent "unfair, deceptive, or abusive acts or practices" in the consumer financial markets. Additionally, Section 1032 of the Dodd-Frank Act authorizes the CFPB to prescribe rules to ensure that the features of a financial product or service are fully, accurately and effectively disclosed to consumers both initially and over the term of the product or service in a manner that permits consumers to understand the costs, benefits and risks associated with the product or service. The CFPB also relies upon Section 1022 of the Dodd-Frank Act to prescribe rules and make exemptions from such rules as necessary or appropriate to carry out the purposes and objectives of the federal consumer financial laws and upon Section 1024 of the Dodd-Frank Act to facilitate supervision of certain non-bank financial service providers.

The proposal would generally cover two categories of loans divided according to the length of the loan term, and each category requires that lenders either: (1) assess a borrower's ability to repay before making the loan ("ability-to-repay requirements"); or (2) in exchange for exemption from ability-to-repay requirements, adhere to certain alternative requirements governing the terms of the loan ("alternative requirements"). Failure to satisfy at least one of these requirements when making a covered loan would constitute an abusive and unfair practice under the proposal.

The CFPB's proposal expressly excludes several types of consumer credit products, 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 lines of credit.

The proposal also contains restrictions on lenders' practices in collecting loan repayments from borrowers, as well as requirements that lenders establish and follow a compliance program, retain certain records and furnish information to registered information systems.

Short-term loans

The proposal would cover short-term credit products that require consumers to pay back the loan in full within 45 days or less, such as payday loans, deposit advance products, certain open-end lines of credit and some vehicle title loans.

- *Short-term loan ability-to-repay requirements*

Under the proposal, lenders would be required to make an upfront determination that a consumer will have the ability to repay a loan before extending credit, including a determination that the consumer would be

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[5] *See* Mulvaney and Neugebauer, Letter to Richard Cordray dated April 8, 2016.

able to make the payments on the loan while meeting the consumer's other financial obligations and basic living expenses without needing to reborrow within 30 days after paying off the loan or making the loan's highest payment.[6]

For each loan, lenders would be required to do the following:

- Verify the consumer's net income.
- Verify the consumer's debt obligations using a national consumer report and a consumer report from a "registered information system."
- Verify the consumer's housing costs or use a reliable method of estimating a consumer's housing expense based on the housing expenses of similarly situated consumers.
- Forecast a reasonable amount of basic living expenses for the consumer— expenditures (other than debt obligations and housing costs) necessary for a consumer to maintain the consumer's health, welfare and ability to produce income.
- Project the consumer's net income, debt obligations and housing costs for a period of time based on the term of the loan.
- Determine the consumer's ability to repay the loan based on this information and the lender's projections.[7]

Lenders would also be restricted from offering additional loans or refinancing options to certain borrowers. For payday loans and single-payment auto title loans, a lender may not offer a loan to a borrower if the borrower had paid off a similar loan within the previous 30 days or seeks to roll over a similar loan. Under the proposal, lenders could only offer a second or third similar short-term loan if a borrower demonstrated that the borrower's financial situation during the term of the new loan would be materially improved relative to what it was since the prior loan was made. These loans would be capped at three in succession followed by a mandatory 30-day "cooling off period."[8] Likewise, for payday installment or auto title installment loans, lenders could not refinance the loan into a loan with similar payments unless a borrower demonstrated that the borrower's financial situation during the term of the new loan would be materially improved relative to what it was during the prior 30 days. However, lenders could refinance the loan if doing so would result in a "substantial reduction" in the borrower's loan payments or total cost of the credit.

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[6] Additionally, for installment loans with a balloon payment, lenders would be required to ensure a borrower can pay all of the payments when due, including the balloon payment, as well as major financial obligations and basic living expenses during the term of the loan and for 30 days after paying the loan's highest payment.

[7] The proposal provides that for a lender's projection of the amount and timing of net income or payments for major financial obligations to be reasonable, the lender must obtain both a written statement from the consumer and certain verification evidence. The projection may be based on a consumer's statement of the amount and timing only to the extent the stated amounts and timing are consistent with the verification evidence.

[8] In supporting this proposal, the CFPB has stated that based on its research, it believes that "if a consumer has obtained three covered short-term loans in quick succession and seeks to obtain yet another covered short-term loan when or shortly after payment on the last loan is due, the fourth loan will almost surely be unaffordable for the consumer."

- *Short-term loan alternative requirements*

The proposal permits lenders to make short-term covered loans without satisfying the ability-to-repay requirement if the loan meets certain requirements and the lender confirms that the consumer met specified borrowing history conditions and provides required disclosures to the consumer.[9]

Under these alternative requirements, a lender could make up to three short-term covered loans in short succession, provided that (1) the first loan has a principal no larger than $500; (2) the second loan has a principal at least one-third smaller than the principal of the first loan; and (3) the third loan has a principal at least two-thirds smaller than the principal of the first loan. However, a lender would be prohibited from making a short-term covered loan if it would result in the consumer having more than six short-term covered loans during a consecutive 12-month period or being in debt for more than 90 days on short-term covered loans during a consecutive 12-month period.

Longer-term loans

The proposal would also cover longer-term loans with terms of more than 45 days, where (1) the lender holds a security interest in the form of a "leveraged payment mechanism" that gives the lender a right to collect payments through access to the consumer's deposit account or paycheck; and (2) the APR (including add-on charges) is more than 36 percent. These would include longer-term vehicle title loans and certain installment and open-end loans, as well as longer-term loans in which the principal is not amortized but is scheduled to be paid off in a large lump sum, or "balloon" payment, after a series of smaller, often interest-only, payments.

- *Longer-term loan ability-to-repay requirements*

Similar to the short-term loan ability-to-repay requirements, lenders would be required to assess a borrower's ability to repay a longer-term covered loan and make all required payments as scheduled. The proposed ability-to-repay requirements for longer-term covered loans closely track the proposed requirements for short-term covered loans. Additionally, when assessing a consumer's ability to repay a longer-term loan, lenders would be required to account for the possibility of volatility in the consumer's income, obligations or basic living expenses during the term of the loan.

A lender would also have to make, under certain circumstances, additional assumptions or presumptions when evaluating a consumer's ability to repay a longer-term covered loan or line of credit. Under the proposal, if a consumer seeks a longer-term covered loan within 30 days of a short-term covered loan or a longer-term balloon payment covered loan, the lender may be required to presume that the consumer is not able to afford a new loan. Similarly, a lender may be required to make a "presumption of unaffordability" if a consumer has shown difficulty in repaying other outstanding covered or *noncovered* loans made by the same lender or its affiliates. In order to overcome a presumption of unaffordability for a new longer-

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[9] The CFPB noted, in supporting this exemption from the ability-to-pay rule, that it recognizes some consumers who would not be able to demonstrate ability to pay at the origination of a loan would be denied loans even though they could, in fact, afford the payment. For example, consumers who are paid, in whole or in part, in cash and do not deposit their wages into a transaction account, preventing verification of their income.

term covered loan, a lender would be required to document a sufficient improvement in the consumer's financial capacity.

- *Longer-term loan alternative requirements*

The proposal provides two conditional exemptions under which lenders would be permitted to make longer-term loans without satisfying the ability-to-pay requirements.

The first exemption would apply to loans that generally satisfy the requirements of the National Credit Union Administration's PAL program. Among other conditions, such loans would be required to have a principal amount between $200 and $1,000, fully amortizing payments, a term of at least 46 days but not longer than six months, an application fee of no more than $20 and an interest rate that is not more than the interest rate permitted for federal credit unions to charge under the PAL regulations.

The second exemption would require a longer-term covered loan to have fully amortizing payments, have a term between 46 days and 24 months and carry a modified total cost of credit of less than or equal to an annual rate of 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. In addition, the projected annual default rate on all loans made pursuant to this second exemption must not exceed 5 percent, and the lender would be required to refund all of the origination fees paid by all borrowers in any year in which the annual default rate exceeds 5 percent.[10]

Collections practices

The proposal also seeks to impose requirements on lenders that obtain access to a consumer's checking, savings or prepaid account to collect payments through methods such as post-dated checks, debit authorizations or remotely created checks.

Under the proposal, lenders would be prohibited from attempting to withdraw payment from a consumer's account in connection with a covered loan after the lender's second consecutive attempt to withdraw payment from the account has failed due to a lack of sufficient funds, unless the lender obtains from the consumer a new and specific authorization to make further withdrawals from the account, while adhering to certain notice and authorization procedures.[11] A lender would also be required to provide consumers with three business days' advance notice before each attempt to withdraw payment for a covered loan from a consumer's bank, credit union or prepaid account. Such notice would contain key information about the upcoming payment attempt, and if applicable, alert the consumer to unusual payment attempts.

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[10] The proposal would define "portfolio default rate" as the sum of the unpaid dollar amount on loans made under the second exemption from the longer-term loan ability-to-repay requirement that were either charged-off during the 12 months of the calculation period or were delinquent for a consecutive period of 120 days or more during the 12-month period for which the rate is being calculated, divided by the average month-end outstanding balances for all such loans for each month of the 12-month period.

[11] This prohibition on further withdrawal attempts would apply whether the two failed attempts are initiated through a single payment channel or different channels, such as the automated clearinghouse system and the check network.

Registered information systems

The CFPB is also proposing that lenders be required to furnish certain information to "registered information systems," including information at the origin of the loan, over the life of the loan and when the loan ceases to be outstanding. Before making most covered loans, a lender would be required to obtain and review a consumer report from a registered information system, which is intended to provide a reasonably comprehensive record of a consumer's recent and current borrowing. The bureau has noted that there are several consumer reporting agencies currently serving the lending markets covered by the proposal that are interested in becoming registered information systems and would be eligible to do so.

Compliance and record retention

Under the proposal, a lender would be required to develop and follow written policies and procedures that are reasonably designed to ensure compliance with the requirements set forth in the proposal and that are appropriate to the size and complexity of the lender and the nature and scope of its covered loan activities. A lender would also be required to retain, among other items, the loan agreement, authorizations and other documentation obtained for a covered loan, as well as electronic records in tabular format regarding loan type and terms, origination calculations and determinations, and payment history and loan performance. Such records would be maintained for 36 months after the date a covered loan ceases to be outstanding.

Effective date

The CFPB is proposing that the proposal become effective 15 months after publication of the final rule in the *Federal Register*, with certain provisions necessary to implement the consumer reporting components of the proposal related to registered information systems becoming effective 60 days after publication of the final rule to facilitate an orderly implementation process.

Conclusion

The CFPB's rulemaking process and the proposal mark one of the most significant efforts to date to provide for federal regulation of an entire consumer finance market not previously subject to federal regulation to this degree. Given the attention paid to the proposal by consumer groups, the consumer lending industry, policy think tanks, Congress and the media, it is likely that the proposal will further evolve through the comment process. Alston & Bird is prepared to assist clients with understanding the proposal and with providing comments to the CFPB.

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Cliff Stanford
404.881.7833
cliff.stanford@alston.com

Ross Speier
404.881.7432
ross.speier@alston.com

ALSTON & BIRD

WWW.ALSTON.COM

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ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BEIJING: Hanwei Plaza West Wing ▪ Suite 21B2 ▪ No. 7 Guanghua Road ▪ Chaoyang District ▪ Beijing, 100004 CN
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213.576.1100
NEW YORK: 90 Park Avenue ▪ 15th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 1950 University Avenue ▪ 5th Floor ▪ East Palo Alto, California, USA, 94303-2282 ▪ 650.838.2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.239.3300 ▪ Fax: 202.239.3333