

Are You Covered? CFPB's Proposed Rule Would Severely Limit High-Cost, Small Dollar Loans

June 03, 2016

On June 2, 2016, the Consumer Financial Protection Bureau (CFPB) released its Proposed Rule that would severely restrict the ability of lenders to make [payday, vehicle title, and certain high-cost installment loans](#). The Rule totals 1,334 pages and was released with, among other things, a 152-page [Supplemental Report](#), which includes factual findings, and a [Request for Information](#) (discussed more below), signaling the potential expansion of such protections. This alert summarizes, at a high level, the most significant aspects of the Rule.

The CFPB issued this Rule pursuant to its authority to regulate “unfair, deceptive, or abusive acts or practices” (UDAAP authority) and, in doing so, stated that it would be an abusive and unfair practice for a lender to make a covered loan without reasonably determining that the consumer has the ability to repay the loan. As proposed, this Rule would apply to all payday loans, vehicle title loans, and certain high-cost installment loans, whether closed-end or open-end, regardless of the form or structure of the credit product, unless exempted.

While the scope of the Rule is limited, bear in mind that this is an instance of the CFPB using its UDAAP authority to deem certain acts or practices abusive if the lender fails to determine whether the consumer has the ability to repay.

We suspect that the CFPB will use its UDAAP authority to extend its regulation of the consumer's ability to repay to other credit products in future rulemakings.

Covered Loans and Exclusions

Yesterday's Rule would apply directly to the following types of consumer credit, unless expressly excluded as described below:

- Any **short-term loan** with a term of 45 days or less
- Any **“longer-term” loan** with a term of more than 45 days where the total cost of credit exceeds 36% per year and the lender obtains either a:
 - Security interest in the consumer's vehicle, or
 - “Leveraged payment mechanism”

The 36% per year trigger would be determined on the basis of an “all-in” APR, which is substantially similar to the Military APR under the Military Lending Act.

What is a Leveraged Payment Mechanism?

The most common form of a “leveraged payment mechanism” is a consumer’s signed ACH recurring payment authorization. However, the Rule more broadly defines this term as any mechanism that gives the lender: (1) the right to initiate a recurring transfer of money from a consumer’s account, (2) the right to obtain payment directly from the consumer’s employer, or (3) the right to obtain payment through a payroll deduction. This definition would include paper checks, remotely created checks, remotely created payment orders, and electronic fund transfer authorizations, among other things.

The Rule provides that a longer-term loan would be covered if the lender obtains a security interest or leveraged payment mechanism at the same time as, or within 72 hours after, the consumer receives the entire amount of funds under the loan. However, if the *loan agreement* authorizes the lender to elect to obtain a leveraged payment mechanism, the loan would still be covered, regardless whether the leveraged payment mechanism is obtained after the expiration of the 72- hour window.

Which Credit Products are Excluded?

- Purchase money loans (except refinances of a purchase money loan);
- Real estate secured credit, including home mortgages and credit secured by personal property used as a dwelling;
- Credit cards;
- Student loans, both federal and private;
- Non-recourse pawn loans; and
- Overdraft services and lines of credit.

Potential Applicability of Rule to Other Credit Products

Although the exclusions leave many mainstream consumer credit products outside of the scope of the Rule, it is clear that the CFPB’s interest in consumer credit products is not limited to those products directly covered by the Rule.

In fact, the CFPB issued concurrently with the Rule a Request for Information on “other potentially high-risk loan products and practices that are not specifically covered” by the Rule, with comments due by October 14, 2016. This Request indicates coming regulation and concern over products and practices not addressed in the Rule, which will likely cover installment loans where the lender does not take a vehicle title as collateral or gain account access.

We also understand that this Request is directed to online marketplace lenders in the burgeoning FinTech space. So even if a credit product is not included in today’s Rule, there is a strong likelihood that it may be included in a future rulemaking. Moreover, the CFPB announced in its Spring 2016 rulemaking agenda that it plans to extend its supervisory authority to cover those and other entities.

Ability to Repay Requirements

For all loans that are covered by this Rule, lenders would be required to ensure the customer has the “ability to repay” before making a covered loan to a consumer. Under the Rule, the failure to determine a consumer’s ability to repay any covered loan would be an abusive practice.

Written Statement and Verification

The Rule would require lenders to obtain a written statement from the consumer to verify the consumer’s ability to repay the loan. In addition, the lender must verify the information provided in the statement, which raises the question of how lenders may quickly and accurately verify a written statement given by a consumer, particularly in an online environment.

“Full Payment Test” for All Covered Loans

Before making a covered loan, the lender would be required to make a reasonable determination that the consumer would be able to make payments and be able to meet the consumer’s other major financial obligations and basic living expenses without needing to reborrow over the ensuing 30 days.

Specifically, a lender would be required to:

- 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” as described below;
- 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 the term of the loan; and
- Determine the consumer’s ability to repay the loan based on the lender’s projections of the consumer’s income, debt obligations, and housing costs and forecast of basic living expenses for the consumer.

Requirements for Longer-Term Loans Only

In addition to the above requirements, the Rule would require lenders of longer-term loans to reasonably account for the possibility of volatility in the consumer’s income, obligations, or basic living expenses during the term of the loan.

Alternatives to Ability to Repay Requirements

For closed-end loans, the Rule provides limited alternatives to the ability to repay requirements.

Short-Term Loans – “Principal Payoff Option”

- Principal amount no greater than \$500
- Loan must be repaid either in a single payment or with up to two extensions where one third of the principal is paid down with each extension
- Vehicle may not be used as collateral
- Disclosures required prior to loan origination

Longer-Term Loans – Two “Less Risky” Options

(1) NCUA “Payday Alternative Loans” and (2) 36% “All-In” APR

NCUA Pal Alternative

- 28% rate cap with application fee of \$20 or less
- Term not more than 6 months
- Loan amount between \$200 and \$1,000
- No prepayment penalty

36% “All-In” APR Alternative

- 36% “all-in” APR rate cap, plus a reasonable origination fee (safe harbor fee is \$50)
- Term not more than 2 years
- If the portfolio default rate exceeds 5% per year, the lender must refund all origination fees for that year

Based on our experience and understanding of the industry, these two longer-term alternatives may not be economically feasible for most lenders in this industry. First, we understand that credit unions have been unable to make the PAL product profitable under the current structure. We estimate that higher-cost installment loan lenders would encounter the same problems. We also predict that the second alternative may not be realistic due to the economics of the 36% rate cap and the potential refund obligation if the portfolio default rate exceeds 5%.

Compliance Requirements for Covered Loans

Payments

The Rule considers more than two attempts to withdraw payment from a consumer’s account in connection with a covered loan to be an abusive and unfair practice. Lenders would be required to provide notice to consumers of covered loans after the second withdrawal attempt and would be required to follow certain procedures in obtaining new authorizations. In addition, a lender would be obligated to provide a written notice at least three business days before each attempt to withdraw payment for a covered loan from a consumer’s checking, savings, or prepaid account. We view this aspect of the Rule as signaling the CFPB’s ongoing interest in payment system issues.

Furnishing Requirements

The Rule also would require lenders to furnish basic loan and borrower information to “registered information systems” for most covered loans at origination. Updates to the originally furnished information would be required over the life of the loan, as well as certain information when the loan is no longer outstanding. The registered information systems would have to meet certain eligibility criteria, which are outlined under the Rule, and must provide a reasonably comprehensive record of a consumer’s recent and current borrowing history. A lender would be required to obtain a review of such record from a registered information system prior to extending certain covered loans to borrowers.

Compliance Program and Recordkeeping

Lastly, as expected, the Rule provides that lenders would be required to establish and follow a compliance program that is reasonably designed to ensure that the lender complies with the requirements in the Rule. Further, the lender would be required to adhere to certain recordkeeping requirements for covered loans, including retaining the loan agreement, related documentation, and additional information in electronic records for 36 months after the last activity on the account.

Timeline

Comments to the Rule are due to the CFPB by September 14, 2016. We anticipate that the CFPB will publish a Final Rule in the Spring of 2017. The effective date of the Final Rule will be 15 months after publication. Accordingly, we estimate that the Final Rule will not be in effect or fully enforced until late 2018.

Over the coming weeks, we will release a series of practical guides analyzing key aspects of the Rule, and its application to industry, in more detail. We will also provide insight on the effect of the Rule on state law and tribal lending activities.

For further information on this topic, please contact a member of the firm’s **Consumer Financial Services Group**.

Related people

Brian Fink