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Client Alert

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CFPB Announces Proposal For Restricting Payday Lending With Potentially Significant Compliance Ramifications

I. Summary. On March 26, 2015, the Consumer Financial Protection Bureau (CFPB) announced its proposal for reforming the short-term lending industry.[1] If rules are adopted in line with the "Outline of Proposals" (the "Proposal"), lenders would have two basic options for continuing their payday lending operations: either (1) confirm upfront that the borrower has the ability to repay the loan through an analysis (and verification) of the borrower's ongoing expenses, or (2) comply with restrictions on the number of loan renewals and offer "no cost off ramps" or an amortizing loan sequence to ensure that the borrower can "affordably repay" the debt. Under either option, a 60-day "cooling off" period is imposed on lending after a 3-loan sequence.

Additionally, the Proposal includes restrictions on collection activities of lenders, including by requiring notice of direct account charge attempts and prohibitions against successive charge attempts when unsuccessful. Finally, the Proposal signals future challenges for lender compliance departments as departments are forced to revamp policies, procedures, and training to meet the demands of the impending new rules.

II. Background. The CFPB announced the Proposal pursuant to its authority under the Consumer Financial Protection Act of 2010, Title X of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").[2] The CFPB specifically cited its authority to "identify and prevent unfair, deceptive, or abusive acts or practices in the consumer financial markets" pursuant to Section 1031 of the Act. It also cited its authority under Section 1032 to issue rules requiring lenders to provide disclosures in connection with products and services.[3]

The next step in the rulemaking process is the creation of a Small Business Advisory Review Panel to identify the impact of the proposed changes on small businesses. This step requires consultations between "small entity representatives" ("SERs") and a government Panel, consisting of representatives of the CFPB, Chief Counsel for Advocacy of the Small Business Administration (SBA), and the Office of Information and Regulatory Affairs in the Office of Management and Budget. A report on the feedback received from SERs during the review process will be issued within sixty days after the Panel is convened. The CFPB will then prepare and issue a Notice of Proposed Rulemaking which will include the text of any proposed rules.

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[1] *See* CFPB Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans, Outline of Proposals Under Consideration and Alternatives Considered, *available at:* http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-businessreview-panel.pdf; *see also* CFPB Fact Sheet: The CFPB Considers Proposal to End Payday Debt Traps, *available at*: http://files.consumerfinance.gov/f/201503_cfpb-proposal-under-consideration.pdf; *and see* Prepared Remarks of Richard Cordray, CFPB Director, *available at*: http://www.consumerfinance.gov/newsroom/prepared-remarks-of-cfpb-director-richard-cordray-at-the-field-hearing-on-payday-lending/

[2] 12 U.S.C. § 5531

[3] 12 U.S.C. §5532.

III. Breakdown of the CFPB's Proposal. The key parts of the proposal are below:

Covered Loans: Two general categories of loans are "covered" by the Proposal. The first are "covered short-term loans" of 45 days or less, including short-term payday loans with a single payment, short-term vehicle title loans, open-end lines of credit repayable or terminating within 45 days, and multi-payment loans due within 45 days. The second category of loans are "covered longer-term loans" of more than 45 days that have an "all-in" APR of more than 36% and that either include access to the borrower's account for repayment or hold a vehicle security interest.

Ability-to-Repay (ATR) Analysis: Lenders would be required to "make a good-faith, reasonable determination" that the borrower has the ability to repay the loan without default or renewal. In doing so, lenders would be required to "obtain and verify" financial information about the borrower, including his or her:

- ***income*** – by obtaining and reviewing bank statements, benefit statements, or paystubs;
- ***major financial obligations*** – by obtaining a credit report as well as copies of receipts, cancelled checks, copies of leases, and/or bank account records; ***and***
- ***borrowing history*** – by reviewing lender's own records as well as checking third-party reporting systems for information about other loans taken over the prior 18 months.

A loan could be made ***only*** if the "consumer's residual income (after considering major financial obligations) is sufficient to support a reasonable determination that the consumer will be able to repay the covered loan while meeting necessary living expenses without reborrowing."[4] In performing the ATR analysis on a longer-term loan with a balloon payment[5], lenders would need to consider income and major financial obligations for 60 days ***after*** the term of the loan.

Presumptions of Inability to Repay and "Cooling Off" Periods: The CFPB also intends to impose a rebuttable presumption that the borrower lacks the ability to repay if a borrower seeks a second or third covered loan in a sequence. To rebut the presumption, the lender would need to obtain evidence of a change in the borrower's financial situation, such as by a pay raise.[6] If there were no change in circumstances, a 60-day cooling off period would be triggered. After a third loan in a sequence, a "conclusive presumption" of inability to repay would preclude any additional loans for the mandatory 60-day cooling off period. Therefore, the proposed new restrictions would allow no more than three loans in a sequence, and each subsequent loan would have to be paired with verifiable improvement in the borrower's financial situation.

Alternative to ATR-Based Lending for Short-Term Loan: As an alternative to performing the ATR determination process, lenders could issue covered short-term loans of no more than $500 after complying with certain alternative screening and protection requirements. These requirements include:

(1) loan principal of $500 or less;
(2) verification of the income and borrowing history;
(3) confirmation that borrower has no other covered loan(s) outstanding;
(4) borrower has not completed a 3-loan sequence (with any lender) in prior 60 days, *i.e.*, compliance with 60-day cooling off period following a 3-loan sequence;
(5) loan would not result in more than six covered short-term loans in rolling 12-months;

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[4] *See* Proposal, at p. 14.

[5] Under the Proposal, a balloon payment is "any payment that is more than two times a regular periodic payment." *See* Proposal, at 25.

[6] The change-in-circumstances could not be "self-certified." *Id.* at 15.

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(6) after completion of loan terms, borrower will not have been in debt on covered short-term loans for more than 90 days during prior 12-month period;
(7) loan is not secured by a vehicle; and
(8) loan is tapered off in one of two proposed ways: (a) lender provides a "no-cost off-ramp"[7] after the third loan in a sequence, or (b) lender reduces the principal amount of subsequent loans so that the debt amortizes over three loans.[8]

Two Alternatives to ATR-Based Lending for Longer-Term Loans: The Proposal also includes an alternative to ATR-based lending if certain screening and debt-trap "protection" requirements are met. Lenders could make longer-term loans in the form of "NCUA-type" loans – *i.e.*, loans meeting the criteria of the National Credit Union Administration's Payday Alternative Loan program – ***or*** in the form of "Maximum PTI" loans.

The following requirements would apply to NCUA-type loans :

(1) lender verifies borrower's income as well as borrowing history and reports use of loan to all commercially available reporting systems;
(2) loan principal between $200 and $1,000;
(3) loan duration between 45 days and six months;
(4) loan charges no more than 28% interest and an application fee of no more than $20;
(5) loan would not result in borrower having more than two covered longer-term loans under the NCUA's Payday Alternative Loan program in a rolling 6-month period; and
(6) loan is fully amortized over no fewer than two payments.[9]

A "Maximum PTI" loan could be made if certain other requirements were met:

(1) lender verifies borrower's income and borrowing history as well as reports use of loan to all commercially available reporting systems[10];
(2) loan duration between 45 days and six months;
(3) periodic payments limited to 5% of borrower's expected gross income during period;
(4) loan would not result in borrower having more than two covered longer-term loans under the Maximum PTI alternative in a rolling 12-month period;
(5) the loan is a closed-end loan repayable in at least two substantially equal payments over no fewer than 45 days;
(6) lender charges no fees for prepayment; and
(7) the borrower has no other covered loan outstanding and has not defaulted on a covered loan in past year.[11]

Lender Collection Practices: The CFPB's Proposal also addresses collection practices involving covered loans. Lenders would be required to provide written notice to borrowers at least three business days before each attempt to collect from a checking, savings, or prepaid account. The following information would also be required on the notice:

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[7] The Proposal describes an off-ramp as a "no-cost extension" of the borrower's third loan made up of "four installments without incurring additional cost." *Id.* at 18.

[8] *Id.* at 20.

[9] *Id.* at 27.

[10] *Id.* at 13 ("To facilitate consideration of borrowing history, lenders would be required to report the use of covered loans to commercially available reporting systems meeting the [CFPB's] eligibility criteria.").

[11] *Id.* at 27-28.

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(1) amount and date of upcoming payment;
(2) payment channel through which the attempt will be made;
(3) a breakdown of the application of payment to principal, interest, and fees;
(4) loan balance if payment succeeds;
(5) name, address, and toll-free number of lender; and
(6) for payment attempts by check, the check number associated with the attempt.

Also, lenders would be prohibited from attempting to collect on an account after two consecutive unsuccessful attempts unless the borrower provides "new payment authorization."

IV. Impacts from the Contemplated Rules.

According to the CFPB's research and simulations, the new proposed rules would "have a significant impact on the volume of payday loans that could be made" if the ATR process is used.[12] The CFPB estimates that the ATR requirement in conjunction with the cooling off rules would result in a drop of storefront short-term lending by between 69% and 84%.[13] The CFPB also estimates that the ATR determination would take "between 15 and 45 minutes" and likely longer should additional visits be required when a borrower does not have adequate documentation to meet the lending requirements. Not surprisingly, the CFPB estimates that the costs of the ATR determination approach would drive lenders to conduct lending operations under the non-ATR "alternative" approaches.[14]

The Proposal also raises important issues in the context of compliance management systems. Should rules be adopted as proposed, lenders would need to ensure that their compliance operations effectively manage the myriad of new requirements, including through the adoption of amended or new policies and procedures to address the following key issues:

- conducting and documenting the ATR analysis and determination;
- checking and reporting covered loan activity through commercially available reporting systems;
- maintaining the accuracy of loan information furnished to a commercially available reporting system;
- documenting changed circumstances required to overcome rebuttable presumption;
- creating and maintaining a loan file for each borrower;
- monitoring performance of covered loans;
- overseeing third-party service providers;
- ensuring creation and transmittal of proper collection notices;
- tracking payment presentments;
- systems for halting payment presentments after unsuccessful attempts;
- documenting subsequent consent for additional presentments;
- filling out and providing disclosures regarding operation of the alternative loan options;
- managing loan off-ramps;
- systems for retaining loan-related records for the requisite 36 month period;
- staff training and testing;
- systems for generating reports of annual reborrowing and default rates for loan portfolios;
- revamping consumer applications and legal agreements; and
- implementing independent monitoring and mystery borrowers.

[12] *Id.* at 42.

[13] *Id.* at 43.

[14] *Id.* at 45.

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In addition, lenders will need to ensure that their policies and procedures properly address other applicable laws, including state payday lending laws as well as other federal laws such as the Fair Debt Collection Practices Act and the Telephone Consumer Protection Act.

V. Conclusion

Whether formal rules will be adopted out of the CFPB's Proposal remains to be seen. In the event they are, however, lenders would be wise to stay ahead of the compliance issues in order to succeed in a short-term credit industry that may see lower margins and fewer players.

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