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PAYDAY LOANS UNDER ATTACK: THE CFPB'S NEW RULE COULD DRAMATICALLY AFFECT HIGH-COST, SHORT-TERM LENDING

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By: Jennifer Janeira Nagle, Robert W. Sparkes, III, Gregory N. Blase, Hayley Trahan-Liptak

On June 2, 2016, the Consumer Financial Protection Bureau ("CFPB" or "Bureau") proposed a new rule under its authority to supervise and regulate certain payday, auto title, and other high-cost installment loans (the "Proposed Rule" or the "Rule"). These consumer loan products have been in the CFPB's crosshairs for some time, and the Bureau formally announced that it was considering a rule proposal to end what it considers payday debt traps back in March 2015. Over a year later, and with input from stakeholders and other interested parties, the CFPB has now taken direct aim at these lending products by proposing stringent standards that may render short-term and longer-term, high-cost installment loans unworkable for consumers and lenders alike. At a minimum, the CFPB's proposal seriously threatens the continued viability of a significant sector of the lending industry.

BACKGROUND

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") provides the CFPB with supervisory authority over certain large banks and financial institutions.[1] The CFPB also wields supervisory authority over all sizes of institutions handling mortgages, payday lending, and private education loans, as well as "larger participants" in the consumer financial products and services markets.[2] The Proposed Rule specifically applies to payday loans, auto title loans, and some high-cost installment loans, and falls under the Bureau's authority to issue regulations to identify and prevent unfair, deceptive, and abusive acts and practices and to assist other regulatory agencies with the supervision of non-bank financial services providers. The scope of the Rule, however, may only be the beginning, as the CFPB has also requested information on other potentially high-risk loan products or practices for future rulemaking purposes.[3]

LOANS COVERED BY THE PROPOSED RULE

The Rule sets forth the regulation of two general categories of loans: short-term loans and longer-term, high-cost loans (together, "Covered Loans"). According to the CFPB, each category of Covered Loans would be regulated in a different manner.[4]

Short-Term Loans

Short-term loans are typically used by consumers in need of a quick infusion of cash prior to their next paycheck. Under the proposed rule, a "short-term loan" would include loans where a consumer is required to repay substantially the entire amount of the loan within 45 days or less.[5] These loans include, but are not limited to, 14-day and 30-day payday loans, vehicle loans, and open-end lines of credit where the plan ends within the 45-

day period or is repayable within 45 days. The CFPB chose 45 days as a means of targeting loans within a single income and expense cycle.

Longer-Term, High-Cost Loans

The Proposed Rule defines longer-term, high-cost loans as loans with (1) a contractual duration of longer than 45 days; (2) an all-in annual percentage rate greater than 36%, including all add-on charges; and (3) either access to a leveraged payment mechanism, such as the customer's bank account or paycheck, or a lien or other security interest on the consumer's vehicle.[6] Longer-term, high-cost loans would also include loans that require balloon payments of the entire outstanding principal balance or a payment at least twice the size of other payments. Such longer-term, high cost loans would include payday installment loans and vehicle title installment loans, among others. Excluded from this definition are loans intended to finance the purchase of a car or goods where the goods secure the loan, mortgages and loans secured by real property, credit cards, student loans, non-recourse pawn loans, and overdraft services.[7]

CONTOURS OF THE RULE

Under the Proposed Rule, the CFPB would deem it an abusive and unfair practice for a lender to extend a Covered Loan to a consumer without first analyzing the consumer's ability to fully repay the loan. In the alternative, lenders will have means to avoid the "ability-to-repay" analysis by offering loans with specific parameters designed to minimize the risk of continued debt, while still providing consumers loans that meet their needs.

Full Payment Test/Ability-to-Repay Determination

Under the Proposed Rule, lenders of Covered Loans would be obligated, prior to extending a loan, to review the borrower's ability to repay the full amount of the loan, including the principal, fees, and interest. To do so, the proposal requires lenders to consider and verify a series of factors including the consumer's (1) net income, (2) basic living expense, and (3) major financial obligations, including housing costs, amounts due on existing debt obligations, and other recurring expenses such as child support.[8] The Rule also requires the lender to secure a national consumer credit report to verify a consumer's debt obligations and court-ordered child support obligations.[9]

Lenders would also be required to make and rely on certain presumptions based on a consumer's loan history in considering their ability to repay.[10] For example, if the consumer assumed another covered short-term loan or a covered longer-term loan with a balloon payment within the prior 30 days, the lender must presume the consumer cannot afford the new loan absent documentation of a sufficient financial improvement. Under the Proposed Rule, a lender is also restricted from making a short-term loan if the consumer has received three covered short-term loans within a 30-day period.

Alternative Loan Requirements

In the Proposed Rule, the CFPB purports to recognize that many consumers rely upon short-term loans for necessary cash and do successfully repay those loans with little or no difficulty. Accordingly, the proposal provides for alternative loans with specific screening and structural requirements to ensure certain protections for consumers. These alternative loans would allow lenders to avoid the extensive fact-checking necessary for the full ability-to-pay inquiry.

- Short-term Loan - Principal Payoff Option: Consumers would be able to borrow up to $500 through a short-term loan, provided that the loan does not include a security interest in a vehicle.[11] The lender could extend the loan only two times, provided that the principal is reduced by one-third each time. The lender, however, would be prevented from extending the loan if it would result in the consumer having more than six covered short-term loans over the most recent 12 consecutive months.[12] Notably, after receiving comment on the potential cost to small lending entities, the Rule drops an earlier suggestion (from March 2015) that would have required lenders to verify a consumer's income prior to extending a short-term loan.
- Longer-term loans - Conditional Exemptions: To extend a longer-term loan, lenders may allow consumers to borrow (1) between $200 and $1,000, (2) for a duration of between 46 days and six months, (3) with fully-amortized payments (to avoid balloon payments), and (4) no more than a 28% interest rate and an application fee of no more than $20.[13] In the alternative, lenders could offer a loan based on (1) a duration of 46 days to 24 months, (2) a modified total cost of credit of less than or equal to an annual rate of 36% with no more than a $50 origination fee, and (3) a projected default rate of less than 5%.[14] Lenders that have a default rate exceeding 5% would be required to refund origination fees for each year that they exceed that threshold. In addition, lenders would not be able to extend a longer-term conditional loan if, after a review of the lender's records and the records of affiliates, the lender determines that the new loan would result in a consumer being in debt on more than two loans made with conditional exemptions.[15] The lender could still provide a Covered Loan following an "ability-to-repay" analysis.

WITHDRAWAL OF PAYMENT

The Rule also touches upon automatic withdrawal of loan payments from consumers' accounts. Specifically, the Rule would deem it an abusive and unfair practice for a lender to attempt to withdraw a payment on a Covered Loan after two consecutive failed withdrawal attempts due to insufficient funds, unless the lender receives new and specific authorization from the consumer to make another withdrawal attempt.[16] Additionally, under the Rule, lenders will need to provide written notice three business days prior to any attempt to withdraw payment from a consumer's checking, savings, or pre-paid account.[17]

TIMING OF RULEMAKING

Comments on the Proposed Rule are due September 14, 2016. The Rule will take effect 15 months after publication of the final rule in the Federal Register with some provisions taking effect 60 days following publication. Comments on the Request for Information regarding emerging risks from other high-risk loan products and practices are due October 14, 2016.

CONCLUSION

The Proposed Rule imposes "ability-to-repay" and other strict requirements on certain payday, auto title, and other high-cost installment loans and may have a profound impact on these consumer lending products and on the industry at large. Indeed, while the Bureau intends for the Proposed Rule to eliminate what it deems potentially abusive and deceptive practices, the Rule would also restrict an important source of often necessary financing for certain consumers. Additionally, while the CFPB has attempted to maintain a framework that would permit lenders to issue certain loans to qualified customers, the very stringent requirements that would govern such loans may cause their undoing.

Notes:

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. Law 111-203, 124 Stat. 1376, §§ 1022, 1024, 1025, 1031, 1032 (2010).

[2] *See id.* at §§ 1022, 1024-26.

[3] Consumer Fin. Prot. Bureau Proposes Rule to End Payday Debt Traps (June 2, 2016), *available at* http://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-proposes-rule-end-payday-debt-traps/.

[4] Consumer Fin. Prot. Bureau, Payday, Vehicle Title, and Certain High-Cost Installment Loans (proposed June 2, 2015), available at http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf .

[5] *Id*. at 170.

[6] *Id.* at 173.

[7] *Id.* at 192.

[8] *Id.* at 280, 288, 290, 293, 510.

[9[*Id.* at 293, 522.

[10] *Id.* at 284, 574.

[12] *Id*. at 1143-44.

[13] *Id.* at 1144-45.

[13] *Id.* at 616-17. These loan requirements and conditions are borrowed in large part from the National Credit Union Administration's Payday Alternative Loan Program. *Id.*

[14] *Id.* at 660, 664.

[15] *Id.* at 667. The lender would not need to review records from unaffiliated lenders or obtain a consumer report. *Id.*

[16] *Id*. at 1108.

[17 *Id.* at 1306-08,1311.

KEY CONTACTS

JENNIFER J. NAGLE
PARTNER
BOSTON
+1.617.951.9197
JENNIFER.NAGLE@KLGATES.COM

ROBERT W. SPARKES, III
PARTNER
BOSTON
+1.617.951.9134
ROBERT.SPARKES@KLGATES.COM

GREGORY N. BLASE
PARTNER
BOSTON
+1.617.951.9059
GREGORY.BLASE@KLGATES.COM

HAYLEY TRAHAN-LIPTAK
ASSOCIATE
BOSTON
+1.617.951.9148
HAYLEY.TRAHAN-LIPTAK@KLGATES.COM

