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CFPB Releases its First Regulatory Proposals Under its UDAAP Authority—Proposing to Level the Playing Field for Payday Loans, Vehicle Title Loans, and Certain High-Cost Installment and Open-End Loans

BY THOMAS P. BROWN, GERALD S. SACHS & MOLLY E. SWARTZ

On March 26, 2015, the Consumer Finance Protection Board ("CFPB" or "Bureau") issued an outline of how the Bureau would propose to use its authority to prohibit unfair, deceptive, and abusive acts and practices ("UDAAP")[1] to regulate payday loans, vehicle title loans, deposit advance products, and certain high-cost installment and open-end loans.[2] The release of these sweeping proposals is the first step towards the CFPB's promulgation of formal regulations governing small-dollar credit products. The proposals distinguish between two types of loans based on duration and interest rate: short-term credit products with contractual durations of 45 days or less; and longer-term credit products with an all-in annual percentage rate ("APR") in excess of 36 percent where the lender obtains a preferred repayment position.[3] Lenders providing these types of loan products are most likely to be affected by the CFPB's future rulemaking efforts.

The Bureau's proposals have two aims. They seek to "prevent" borrower default by requiring lenders to assess a potential borrower's ability to repay a debt prior to issuing a loan, and they seek to "protect" against borrower default by restricting the terms on which lenders extend credit. As discussed below, the approach outlined in the CFPB's release is highly proscriptive. It dictates very specific procedures that small-dollar lenders must take in assessing the creditworthiness of borrowers and very specific contract terms related to repayment, amortization, collections, and, to a degree, interest rate. As a result, lenders providing credit products covered by the proposals may be required to restructure their existing businesses.

Although the current proposals are non-binding, they signal the beginning of the CFPB's rulemaking process. Following this release, the CFPB will present its regulatory outline to a Small Business Review Panel and receive comments from the Panel.[4] Once that process is complete, the CFPB can be expected to issue a proposed rule and begin soliciting public comment. After a public comment period, the CFPB will re-consider its proposed rule and promulgate a final rule.

While the precise contours of any proposed rule can be expected to evolve over the coming months, the outlined proposals represent a fairly dramatic extension of the Federal government's role in the small-dollar credit industry. We provide a summary of the proposals below.

I. SHORT-TERM LOANS

The short-term loan proposals under consideration would cover credit products that require consumers to pay back the loan in full within 45 days,[5] including short-term payday loans with a single payment, vehicle title loans, open-end lines of credit, and multi-payment loans (collectively, "short-term loans").

Short-term lenders would be required to undertake one of the following approaches to evaluating whether to extend credit: (1) make a determination that the consumer has an ability to repay prior to extending credit (an "ATR Determination"); or (2) satisfy certain screening and structural requirements in issuing a loan ("Alternative Requirements").

A. Ability-To-Repay Determination

In order to make an ATR Determination for a covered short-term loan, a lender will need to make what, on its face, appears to be an underwriting decision and comply with additional requirements that turn on the precise nature of the product or the circumstance in which the consumer is requesting the loan.

1. Good-Faith Reasonable Determination

The centerpiece of the ATR element is a requirement that a lender make a "good-faith, reasonable determination" that the consumer has the ability to repay the entire loan—including interest, principal, and fees for add-on products—without re-borrowing or defaulting. A lender would need to verify a consumer's income, major financial obligations, and borrowing history using bank statements, pay stubs, receipts, leases, and similar documents. If the borrower fails the ATR Determination, the lender would be prohibited from extending a loan.

The CFPB anticipates that information related to a consumer's borrowing history could be determined from commercially available consumer reporting systems, which many lenders already utilize in determining whether to extend a loan. As part of the proposals, the CFPB would specify criteria to make a consumer reporting system eligible for lenders to use in verifying borrowing history, and would require lenders to report the use of loans to these reporting systems.[6]

2. Presumptions Regarding Repeat Loans

To prevent a consumer from taking out multiple loans that cannot be repaid, the CFPB proposes the creation of a presumption that the consumer lacks the ability to repay additional short-term loans taken out within 60 days of a prior outstanding short-term loan. To rebut this presumption,[7] the lender would need to determine that the consumer has the ability to repay each loan by verifying a change in circumstances. This might include, for example, documentation of a pay raise or evidence that major financial obligations had decreased following the prior loan. However, after three short-term loans in sequence, lenders would be categorically prohibited from making a new short-term loan to a consumer for a 60-day "cooling off" period.

3. Open-End Lines of Credit

If the open-end line of credit terminates within 45 days or the credit is repayable in full within 45 days, then the lender would have to consider the borrower's ability to repay using these assumptions: (1) that a consumer fully utilizes the credit upon origination and makes only the

minimum required payments until the end of the contract period, at which point the consumer makes a single payment in the amount of the remaining balance and any remaining finance charges; or (2) that a consumer makes full repayment by the payment date specified in the contract.

B. Alternative Requirements for Short-Term Loans

If a lender wants to provide short-term loans without conducting the ATR Determination, the lender can do so using certain alternative screening requirements, provided that the loan also contains specific structural protections.

1. Screening requirements

The Bureau has proposed the following requirements that a lender must use when evaluating the consumer for loan eligibility. The lender must verify the following:

- The consumer's income;
- The consumer's borrowing history;
- The consumer does not currently have an outstanding short-term loan;
- The consumer does not have more than three such alternative loans in a sequence and has not completed a three-loan sequence of alternative loans from any lender within the past 60 days;
- The loan would not result in the consumer receiving more than six short-term loans from any lenders in a rolling 12-month period; and
- The duration of the loan would not result in the consumer being in debt with any short-term lenders for more than 90 days in aggregate during a rolling 12-month period.

2. Structural protections

Provided the proposed screening criteria have been met, a lender may extend a loan that meets the following structural protections:

- Does not exceed $500;
- The term is not greater than 45 days;
- There is no security interest in a vehicle as collateral; and
- The loan tapers off consumer indebtedness.

This fourth criterion may be met in one of two ways. First, the lender may reduce the principal amount over a three-loan sequence. For example, if a first loan had a principal of $300, a lender could extend a second loan under the alternative requirements within 60 days of the first loan only if the loan principal were no more than $200. Second, the lender could provide a no-cost "off-ramp" if the borrower is unable to repay after the third loan. This "off-ramp" would enable a consumer to repay the third loan over an additional four installments without incurring any cost.

II. LONGER-TERM LOANS

The longer-term loan proposals under consideration would cover credit products with a contractual duration longer than 45 days and an all-in APR in excess of 36 percent[8] where the lender has the right to obtain repayment from a consumer's bank account, prepaid account, paycheck,[9] or holds a non-purchase money security interest in the consumer's vehicle (collectively, "longer-term loans"). The proposals also cover vehicle title loans characterized as title pawn transactions or loans with second or lower priority vehicle liens.

As with short-term lenders, a longer-term lender would be required to either engage in an ATR Determination or satisfy the Alternative Requirements.

A. Ability-to-Repay Determination

Although this ATR Determination is similar to the CFPB's ATR Determination proposal for short-term loans, it adds an extra component in that lenders would be required to make a good-faith, reasonable determination that a borrower will be able to repay the loan *each* time the borrower seeks to refinance or re-borrow.

1. Presumptions Applicable to Refinances of Prior Debt

The ATR Determination would attach to each consideration of an extension of a longer-term loan. The CFPB has suggested that lenders presume that a consumer lacks the ability to repay a longer-term loan if the following occur at the time of refinancing:

- The consumer is delinquent or had recently been delinquent on the loan seeking to be refinanced;
- The consumer has indicated an inability to make a scheduled payment under the loan being refinanced or the loan being refinanced has caused financial distress;
- The refinancing provides a skipped payment that otherwise would have been due, unless the refinancing provides for a substantial amount of cash out to the consumer; or
- The loan being refinanced is in default.

2. Presumptions Applicable to Loans with Balloon Payments

The presumptions regarding a consumer's inability to repay for repeat loans described above in reference to short-term loans would also apply to loans with balloon payments.[10] These presumptions would apply to any transaction where the new loan is a longer-term loan and the prior debt is from the same lender. The presumptions would also apply to any transaction where the new loan is a longer-term loan and the debt being refinanced is a short-term or longer-term loan from any lender.

3. Open-End Lines of Credit

As with short-term open-end lines of credit, the CFPB would require the lender to consider the borrower's ability to repay using these assumptions: (1) that a consumer fully utilizes the credit upon origination and makes only the minimum required payments until the end of the contract period, at which point the consumer is assumed to make a single payment in the amount of the remaining balance and any remaining finance charges; or (2) that a consumer makes full repayment on the loan by the end of the contract period or, if no termination date is specified, six months from the date of origination.

B. Alternative Requirements for Longer-Term Loans

A lender may also make longer-term loans without conducting the ATR Determination, if lender engages in alternative screening requirements and the loan extended includes specific structural protections. Different requirements apply based on the type of longer-term loan being offered:

1. National Credit Union Administration (NCUA)-Type Loans Alternative Requirements

A lender that provide loans that satisfy the requirements of the *Payday Alternative Loan* program under the National Credit Union Administration ("NCUA") regulations may avoid an ATR Determination under certain circumstances. The lender can do so using certain alternative screening requirements, provided that the loan also contains specific structural protections.

a. Screening Requirements

The Bureau has proposed the following requirements that a lender must use when evaluating the consumer for loan eligibility. The lender must do the following:

- Apply minimum underwriting standards and verify the consumer's income;
- Verify borrowing history;
- Verify that the consumer has no other loans outstanding; and
- Verify that the loan would not result in the consumer having more than two such loans during a rolling six-month period.

b. Structural Protections

Provided the proposed screening criteria have been met, a lender may extend a loan that meets the following structural protections:

- The loan has a principal of $200 to $1,000;
- The loan has a maximum term of six months;
- The lender charges no more than a 28 percent annualized interest rate and an application fee, reflecting the actual costs of processing the application, of no more than $20;
- The lender fully amortizes the loan over no fewer than two payments; and
- The loan has a minimum term of 45 days.

Lenders that hold a deposit account in the consumer's name would also be prohibited from charging the account to a negative balance or closing the account in the event of delinquency or default.

2. Maximum Payment-to-Income (PTI) Loans

A lender that provides loans with payments below a five payment-to-income (PTI) ratio may avoid an ATR Determination under certain circumstances. The lender can do so using certain alternative screening requirements, provided that the loan also contains specific structural protections.

a. Screening requirements

The Bureau has proposed the following requirements that a lender must use when evaluating the consumer for loan eligibility. For example the lender must verify the following:

- The consumer's income;
- The consumer's borrowing history;
- The consumer has no other loans outstanding and has not defaulted on a loan within the past 12 months; and
- The loan would not result in the consumer having more than two such loans during a rolling 12-month period.

b. Structural Protections

Provided the proposed screening criteria have been met, a lender may extend a loan that meets the following structural protections:

- The periodic payment due on the loan is no more than five percent of the consumer's expected gross income during this same period;
- The loan is a closed-end loan repayable in at least two substantially equal payments over no fewer than 45 days;
- The loan has a maximum duration of no more than six months; and
- The lender charges no fees for prepayment of the loan.

III. COLLECTION PRACTICES

Both short-term and longer-term lenders often have access to consumers' bank accounts or payroll cards for repayment. To avoid unanticipated withdrawals and debits, the CFPB is considering proposals to require borrower notification before accessing deposit accounts and to limit lenders' attempts to collect payment after unsuccessful withdrawal attempts.

A. Borrower Notification

Lenders would be required to provide a written notice to consumers at least three business days in advance of any attempt to collect payment from a consumer's checking, savings, or prepaid account. The notice would contain certain information about the collection attempt, such as the exact amount and date of the upcoming payment collection attempt, a break-down of the application of payment amount to principal, interest, and fees, and/or the loan balance remaining if the payment collection attempt succeeds. This would likely require small entities to develop systems or procedures to collect this information and prepare notices, or to invest in technology to do so.

B. Limited Withdrawal Attempts

Lenders would be prohibited from attempting to collect payment from a consumer's account after two consecutive attempts have failed, unless the consumer has provided a new authorization. To the extent that lenders are able to successfully collect fees after two collection attempts, they will no longer be able to do so. Notably, this proposal is more restrictive than the existing National Automated

Clearing House Association ("NACHA") Operating Rules, which restrict lenders from making more than three attempts to collect a single payment via the ACH system.

IV. COMPLIANCE MEASURES

The CFPB proposals would require lenders to maintain formal policies and procedures to ensure compliance with the substantive measures of any proposed rule. These might include procedures for determining a consumer's ability to repay, ensuring structural protections on loans, reporting accurate information to consumer reporting companies, maintaining accurate and up-to-date loan files, and ensuring consumers receive all required disclosures.

V. OUTSTANDING ISSUES UNDER THE PROPOSALS

A. Potential Regulatory Impact

Although the CFPB proposals provide only broad parameters for what could serve as a framework for an eventual rule, the proposals represent a significant shift from the existing regulatory environment. While many lenders must comply with a number of federal laws broadly applicable to all types of credit products, *e.g.*, the Truth in Lending Act,[11] Fair Credit Reporting Act,[12] Equal Credit Opportunity Act,[13] Fair Debt Collection Practices Act,[14] Gramm-Leach Bliley Act,[15] etc., there are no specific federal standards governing the provision of shorter term payday-related credit products. Beyond simply establishing a federal floor for small-dollar loan products, however, the CFPB's proposals threaten to disrupt existing payday lending models.

As drafted, the proposals would make it difficult, if not impossible, for many providers of small-dollar loan to carry on in their current form. To make an ATR Determination under the proposals, for example, many storefront short-term lenders would need to invest capital in the technological improvements necessary to collect and assess consumers' income sources, financial obligations, and borrowing history. While internet-based credit providers may be able to incorporate these inputs with ease, brick-and-mortar lenders may be forced to re-evaluate existing business processes. For some lenders, this may mean that short-term lending no longer makes good business sense.

Further, loan restructuring requirements could severely impact lenders' revenue generation. Payday loan loss estimates are already significant. The addition of required off-ramps could delay repayment and limit the fees a lender can assess for late payment. The required 60-day "cooling off" periods between loans could deter some consumers from seeking additional loans all together, thus decreasing lender revenue. Amortization requirements could drastically reduce lender fees as the second and third loans in a sequence would be required to be smaller than the first loan.

Even with some modification through the regulatory process, the proposals put forward by the CFPB would likely produce a dramatic shift in the small-dollar lending industry. Recognizing that the final rule may vary from the proposals put forward by the CFPB, we believe that participants in the industry should begin taking steps today to plan for a more federally regulated future.

B. Action Plan

Lenders should consider undertaking the following:

- Analyze your existing credit products that may be affected by the proposals;
- Consider whether your credit products meet the regulatory framework identified within the CFPB's proposals;

- Determine the best method to modify product offerings should a proposed rule follow the CFPB's proposals;
- Assess the burden or costs that the CFPB's proposals, if any, would have on your business;
- Identify any potential impacts of the CFPB's proposals that would create an unworkable challenge for your operations;
- If you are a depository institution, consider whether the proposals' application to deposit advance products would supplement and/or conflict with existing Office of the Comptroller of the Currency Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products;[16]
- Continually monitor for future CFPB developments regarding regulation of small-dollar loans, including the issuance of a proposed rule;
- Consider whether it may be appropriate to meet with the CFPB to provide data or relevant information articulating your concerns or the regulatory burden these proposals would impose; and
- Be prepared to submit comments during the public comment process once a proposed rule has been issued.

Paul Hastings attorneys are actively working with clients to identify and address the impact of the proposals on their operations.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

San Francisco

Thomas P. Brown
1.415.856.7248
tombrown@paulhastings.com

Molly E. Swartz
1.415.856.7238
mollyswartz@paulhastings.com

Washington D.C.

Gerald S. Sachs
1.202.551.1975
geraldsachs@paulhastings.com

[1] The CFPB has issued these proposals, and intends to issue regulations, under sections 1031 and 1032 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 12 U.S.C. § 5481 *et seq*. ("Dodd-Frank Act"). Section 1031 of the Dodd-Frank Act authorizes the CFPB to issue rules to identify and prevent unfair, deceptive, or abusive acts or practices in the consumer financial markets. *See* 12 U.S.C. § 5531(b). Section 1032 of the Dodd-Frank Act authorizes the CFPB to prescribe rules that ensure that the features of a consumer financial product are fully, accurately, and effectively disclosed. *See* 12 U.S.C. § 5532(a).

[2] The CFPB proposals cover loans obtained "by consumers primarily for personal, family, or household purposes; these proposals do not extend to loans obtained for business purposes. 12 U.S.C. § 5481(5) (defining "consumer financial products or services"); 12 U.S.C. § 5531(b) (authorizing the CFPB to issue rules to identify and prevent unfair, deceptive, or abusive acts or practices in the consumer financial markets).

[3] Notably, these proposals do not cover (1) bona fide non-recourse pawn loans with a contractual duration of 45 days or less where the lender takes possession of the collateral (though vehicle title loans characterizes as "title pawn" transactions would be covered); (2) credit card accounts; (3) real estate secured loans; and (4) student loans. Deposit account overdraft services are also excluded from the proposals.

[4] *See* Small Business Regulatory Enforcement Fairness Act (SBREFA), 5 U.S.C. § 609(b). In addition to government representatives, the Panel will include representatives from small businesses and not-for-profits that may be subject to the rules that the Bureau may issue.

[5] Although pay periods typically vary from one week to one month, the CFPB has set a 45 day period as an upper bound for "short-term loans" to accommodate loans made shortly before a consumer is paid, which could result in loans that are slight more than a month long.

[6] The CFPB does not intend to create its own reporting system or administer a third-party reporting system.

[7] The CFPB has suggested that it will consider a short-term loan to be part of a loan sequence if, within the past 60 days, the consumer has another outstanding short-term loan or a longer-term loan with balloon payment.

[8] Notably, the CFPB takes the 36 percent APR ceiling from the Military Lending Act's limitation on the cost of credit extended to military service-members and their dependents. 32 C.F.R. § 232. This calculation would include interest, fees, and the cost of any add-on products such as credit insurance, memberships, and other products sold along with the credit.

[9] A lender could also gain account access through a post-dated check, an automated clearinghouse (ACH) authorization, a remotely created check (RCC) authorization, an authorization to debit a prepaid card account, a right of setoff or to sweep funds from a consumer's account(s), and other methods of collecting payment from a consumer's checking, savings, or prepaid account, as well as a payroll deduction.

[10] A balloon payment would be any payment that is more than two times a regular periodic payment.

[11] 15 U.S.C. § 1601 *et seq.*

[12] 15 U.S.C. § 1681 *et seq.*

[13] 15 U.S.C. § 1691 *et seq.*

[14] 15 U.S.C. § 1692 *et seq.*

[15] 15 U.S.C. § 6801 *et seq.*

[16] Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products, Office of the Comptroller of the Currency, Docket ID OCC-2013-005 (Nov. 26, 2013), *available at* http://www.occ.gov/news-issuances/news-releases/2013/nr-ia-2013-182a.pdf.

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