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CFPB Proposes New Rule Targeting Small Dollar Loans, Relies on UDAAP Rulemaking Authority for First Time

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The Consumer Financial Protection Bureau (“CFPB” or “Bureau”) proposed new regulations on June 2, 2016 to reform certain small dollar lending practices, including “payday debt traps” that allegedly push consumers into a cycle of reborrowing with accumulating fees and interest.¹

While the intention of the proposed small dollar loan rule may be laudable—to strengthen financial protections for “consumers who are living paycheck to paycheck, have little to no access to other credit products, and seek funds to meet recurring or one-time expenses”²—the proposed rule has broad potential implications for more than just payday lenders. Any business that offers loans, including longer term installment loans, must grapple with the Bureau’s proposed rule. With the comment window set to close on September 14, 2016, now is the time for consumer lenders to evaluate their current business practices and potential exposure, and consider submitting a comment in response to the proposed rule.

I. Background

The CFPB issued the proposed rule pursuant to its authority under a number of Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) provisions, including Section 1031 (to identify and prevent unfair, deceptive, or abusive acts or practices, also known as “UDAAPs”),³ Section 1022 (to prescribe rules and make exemptions from such rules as is necessary or appropriate to carry out the purposes and objectives of the consumer Federal consumer financial laws),⁴ Section 1024 (to facilitate supervision of certain non-bank financial service providers),⁵ and Section 1032 (to require disclosures to convey the costs, benefits, and risks of particular consumer financial products or services).⁶

Of particular note is the CFPB’s UDAAP authority under the Dodd-Frank Act, which authorizes the Bureau to take actions to prevent certain persons or service providers from committing or engaging in an unfair, deceptive, or abusive act or practice in connection with any transaction with a consumer for a consumer financial product or service, or the offering of a consumer financial product or service.⁷ This authority is specifically defined by the Dodd-Frank Act and further clarified by case law. The Dodd-Frank Act defines “unfairness” as an act or practice that is likely to cause or actually causes substantial injury to consumers, which is not reasonably avoidable by consumers, and the injury is not



outweighed by countervailing benefits to consumers or to competition.⁸ “Deception” is generally defined as a representation or omission that is likely to mislead or actually misleads a consumer and is material to the consumer, where the consumer is acting reasonably under the circumstances.⁹ The newest addition, which expands the CFPB’s authority beyond the FTC’s legacy unfair and deceptive authority,¹⁰ defines an “abusive” practice as a representation or omission that:

1. materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
2. takes unreasonable advantage of (a) a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service, (b) the inability of the consumer to protect the consumer’s interests in selecting or using a consumer financial product or service, or (c) the reasonable reliance by the consumer on the financial services provider to act in the interests of the consumer.¹¹

In discharging this authority within the context of consumer lending, the CFPB studied certain types of loans made to consumers “facing liquidity shortfalls, including payday loans, vehicle title loans, and certain types of installment loans,” conducted supervisory examinations of payday lenders, and pursued public enforcement actions against creditors making payday loans, vehicle title loans, and similar forms of credit prior to crafting the proposed rule.¹² Based on this market monitoring and research, the CFPB concluded that certain practices trap borrowers in debt they cannot afford. These practices include allowing borrowers to roll over short term loans, aggressively pursuing borrowers for outstanding debts, seizing cars pledged as collateral, imposing penalty fees on borrowers who miss payments, and triggering involuntary account closures as a result of rejected debits by online payday lenders.¹³ As the text of the proposed rule notes, these considerations led to the Bureau’s particular focus on lenders with business models that “deviate substantially from the practices in other credit markets by failing to assess consumers’ ability-to-repay their loans and by engaging in harmful practices in the course of seeking to withdraw payments from consumers’ accounts.”¹⁴

II. Scope of Proposed Rule

As drafted, the proposed rule covers the following categories of payday loans, vehicle title loans, and certain high-cost installment loans (collectively “covered loans”): (1) loans with a term of 45 days or less; and (2) loans with a term greater than 45 days, provided that they (a) have an all-in annual percentage rate greater than 36% and (b) either are repaid directly from the consumer’s account or income or are secured by the consumer’s vehicle.¹⁵ The proposed rule does not cover (1) loans extended solely to finance the purchase of a car or other consumer good in which the loan is secured by the good; (2) home mortgages and other loans secured by real property or a dwelling if recorded or perfected; (3) credit cards; (4) student loans; (5) non-recourse pawn loans; and (6) overdraft services and lines of credit.¹⁶

For loans covered by the rule, lenders will be required to determine if the consumer has the ability to repay the loan on the terms offered. The rule defines a consumer’s ability to repay as the ability to make payments on the loan and meet his or her other major financial obligations without needing to borrow additional funds within a 30 day period.¹⁷ Apart from its scope, the proposed rule is significant because it represents the first time that the Bureau has invoked its authority to ban abusive practices to justify a proposed regulation.¹⁸

If a potential borrower does not meet the “full-payment test,” the proposed rule provides lenders the following options for providing credit.



- **For short-term loans**, the lender may extend credit if the lender provides required disclosures, the loan meets certain restrictive terms, and the borrower's credit history meets certain criteria. For example, a lender would be permitted to make up to three covered short-term loans, provided that the first loan has a principal amount no larger than \$500, the second loan has a principal amount at least one-third smaller than the principal amount on the first loan, and the third loan has a principal amount at least two-thirds smaller than the principal amount on the first loan.¹⁹ Notwithstanding the foregoing, a lender may not make a covered short-term loan under this alternative option if the consumer would then have more than six covered short-term loans during a consecutive twelve-month period or be in debt for more than 90 days on covered short-term loans during a consecutive twelve-month period.²⁰ A lender opting to use this alternative may not take a security interest in the borrower's vehicle.²¹
- **For long-term loans**, the lender may extend credit under either of the following two alternatives: (1) an option modeled from the National Credit Union Administration's Payday Alternative Loan program (in which the principal amount of the loan is between \$200 and \$1,000, repayment is in two or more payments that are fully amortizing, the term is between 46 days and six months, the annualized interest is not more than 28%, and the application fee is \$20 or less); or (2) a loan structure in which the total cost of credit does not exceed an annual rate of 36% (excluding a single origination fee of up to \$50 or one that is a "reasonable proportion" of the lender's underwriting costs), the loan term is between 46 days and 24 months, the loan is repayable in two or more payments that are fully amortizing, and the lender's projected default rate on all loans made using this option does not exceed 5%.²² If the default rate in any year exceeds 5%, the lender would be required to refund all origination fees during the year in which the 5% rate is exceeded.²³

Payment Practices. In response to the risk of involuntary bank account closures identified by the Bureau,²⁴ the proposed rule also includes requirements specific to payments practices for covered loans. In particular, the rule would prohibit lenders from attempting to collect payment on a covered loan from a borrower's account two or more times, to the extent that these attempts are due to insufficient funds, absent a new and specific authorization from the consumer to withdraw from the account.²⁵ Lenders would also be required to provide the consumer with written notice of at least three business days before attempting to withdraw a loan payment from the consumer's checking, savings, or prepaid account.²⁶

Loan Level Reporting. The Bureau has also proposed requirements that lenders report information specific to covered loans spanning origination, servicing, and final disposition of the debt. The information on covered loans to registered information systems would provide lenders access to a record of consumers' borrowing history specific to covered loans, which is designed to be used in connection with the required ability to pay determinations.²⁷

It is particularly notable that the proposed requirements would not displace state law. Because state consumer lending laws—including those specific to interest rate, principal amount, and loan term—would remain in force, loans permitted under the proposed rule would only be authorized to the same extent as under state law.

In addition to releasing the proposed rule, the CFPB also issued a request for information ("RFI") seeking to obtain additional information on financial products that fall outside the scope of the proposed rule, but that also could be deemed to be "high-cost products, where the risks to consumers



from making unaffordable payments may be similar to the types of harms detailed in the [proposed rule].²⁸ The Bureau explained that it is seeking this feedback to “understand whether there is a need and basis for potential future efforts, including but not limited to future rulemakings, supervisory examinations, or enforcement investigations.”²⁹ The RFI also seeks information on practices that are not covered by the proposed rule, including practices in which lenders may make it difficult for borrowers to repay their debts, as well as marketing tactics. Accordingly, additional action by the Bureau in this market beyond the scope of the proposed rule may be forthcoming.

III. Market Concerns

With the proposed rule now open for public comment, the CFPB has been careful to note that it does “not intend to disrupt the basic underwriting approaches taken by many banks, credit unions, and traditional finance companies, as well as some newer entrants, which offer installment loans in ways designed to assure that consumers can afford to repay them.”³⁰ The Bureau has further noted that it anticipates that lenders will have “little difficulty” adhering to the requirements of the proposed rule.³¹ This stance may be untenable for lenders that service riskier borrowers with short-term loans, however, as they must assess a higher interest rate to cover the greater likelihood of default.

These new regulations could also be just the tip of the iceberg when it comes to new federal initiatives to regulate high-interest consumer loan products. At a recent field hearing on small dollar lending in Kansas City, CFPB Director Richard Cordray emphasized that, as the Bureau moves forward with its rulemaking process, it will also launch “a related inquiry into other situations that may harm consumers,” including a further range of products and practices that fall outside the scope of the payday lending proposal, such as “high-cost, longer-term installment loans and open-end lines of credit that lack vehicle security or an account access feature.”³²

While the CFPB has expressed its desire to ensure that low-income borrowers are able to access credit when needs arise, the proposed rule’s restrictions may drive current providers out of business and be too stringent to attract banks to offer products in this market. The proposed rule would further shrink margins for lenders seeking to provide credit to low-income borrowers. Importantly, the 36% “all-in annual percentage rate” will in many cases effectively limit interest rates to far below 36%, as it includes many charges that are excluded from the definition of “annual percentage rate” under existing lending regulations.³³

Online marketplace lenders, however, may be able to more nimbly respond to the new requirements of the proposed rule, and may look to the proposed rule, if finalized, as an opportunity to gain greater market share in the small-dollar credit space.

IV. Action Items

The Bureau has proposed that the small dollar loan rule would become effective 15 months after publication of the final rule in the Federal Register. Lenders offering covered loans should consider whether it would be appropriate to submit a comment letter in response to the CFPB’s proposed rule detailing the likely effects on the industry and the availability of credit for borrowers facing liquidity shortfalls. Comments are due by September 14, 2016.

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¹ See Press Release, Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps, CFPB (June 2, 2016), available at http://files.consumerfinance.gov/f/documents/CFPB_Proposes_Rule_End_Payday_Debt_Traps.pdf; CFPB, Payday, Vehicle Title, and Certain High-Cost Installment Loans, Docket No. CFPB-2016-0025 (proposed June 1, 2016) (to be codified at 12 CFR Part 1041) [hereinafter Proposed Rule] available at http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

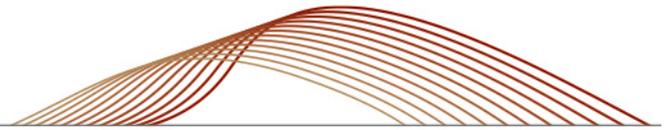
² Proposed Rule at 3.

³ Public Law 111-203, § 1031(b), 124 Stat. 1376 (2010) [hereinafter Dodd-Frank Act].

⁴ *Id.* § 1022(b).

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⁵ *Id.* § 1024(b)(7).

⁶ *Id.* § 1032(a).

⁷ See 12 U.S.C. § 5531(a).

⁸ See 12 U.S.C. § 5531(c)(1).

⁹ See CFPB, *Marketing of Credit Card Promotional APR Offers*, Bulletin 2014-02 (Sept. 3, 2014), available at http://files.consumerfinance.gov/f/201409_cfpb_bulletin_marketing-credit-card-promotional-apr-offers.pdf (noting that “the standard for ‘deceptive’ practices in the Dodd-Frank Act is informed by the standards for the same terms under Section 5 of the FTC Act”); see also CFPB, *CFPB Supervision and Examination Manual*, at UDAAP 5 (Oct. 2012), available at http://files.consumerfinance.gov/f/201210_cfpb_supervision-and-examination-manual-v2.pdf.

¹⁰ See 12 U.S.C. § 45(a) (Section 5 of the Federal Trade Commission Act prohibits “unfair or deceptive acts or practices in or affecting commerce.”).

¹¹ 12 U.S.C. § 5531(d)(1)–(2).

¹² Proposed Rule at 3–4.

¹³ See Press Release, Consumer Financial Protection Bureau Proposes Rule to End Payday Debt Traps, CFPB (June 2, 2016), available at http://files.consumerfinance.gov/f/documents/CFPB_Proposes_Rule_End_Payday_Debt_Traps.pdf.

¹⁴ Proposed Rule at 4.

¹⁵ *Id.* at 1.

¹⁶ *Id.* at 5.

¹⁷ *Id.* at 6.

¹⁸ *Id.* at 5–6.

¹⁹ *Id.* at 7.

²⁰ *Id.* at 8.

²¹ *Id.* at 8.

²² *Id.* at 9.

²³ *Id.* 9–10.

²⁴ *Id.* 696–97.

²⁵ *Id.* at 10.

²⁶ *Id.* at 10.

²⁷ *Id.* at 10–11.

²⁸ CFPB, Request for Information on Payday Loans, Vehicle Title Loans, Installment Loans, and Open-End Lines of Credit, Docket No. CFPB-2016-0026, at 6 (June 1, 2016), available at http://files.consumerfinance.gov/f/documents/RFI_Payday_Loans_Vehicle_Title_Loans_Installment_Loans_Open-End_Credit.pdf.

²⁹ *Id.*

³⁰ See Press Release, Prepared Remarks of Richard Cordray, Director of the Consumer Financial Protection Bureau, Field Hearing on Small-Dollar Lending in Kansas City, Mo., CFPB (June 2, 2016), available at <http://www.consumerfinance.gov/about-us/newsroom/prepared-remarks-richard-cordray-director-consumer-financial-protection-bureau/>.

³¹ *Id.*

³² *Id.*

³³ See 12 C.F.R. § 1026.22; Proposed Rule at 162–63.