Earlier this summer, the CFPB issued its proposed payday rule. Hailed as an attempt to end “payday traps”, the 1,334-page missive addresses both short term loans and certain longer term high-cost loans. In addition to restricting the structure of loans, the proposed rule places limitations on how lenders collect on covered loans and mandates extensive record retention policies. The comment period regarding the proposed rule runs through September 14, 2016, and stakeholders are encouraged to review the proposed rule carefully and submit comments as appropriate.

In a Nutshell. The proposed rule places limitations on short-term loans, as well as certain higher cost longer term loan products. Covered short-term credit products include products that require the consumer to pay back the loan in full within 45 days. Proposed 1041.3(b)(1). Covered longer term loan products are those which have a total cost of credit exceeding 36% and are repaid directly from the consumer’s account or income or are secured by the consumer’s vehicle. *See* Proposed 1041.3(b)(2). The proposed rule applies to a wide variety of loan products and will impact nonbank lenders, as well as banks and credit unions. Importantly, the payday rule excludes from coverage purchase money security credit secured solely by a car or other purchased consumer goods, real property or dwelling-secured credit if the lien is recorded or perfected, credit cards, student loans, non-recourse pawn loans, overdraft services and lines of credit. Proposed 1041.3(e).

Short Term Loan Products

When the CFPB first rolled out its payday proposal in 2015, it couched its two alternatives for lenders making short terms loans as “prevention” and “protection”. The proposed rule leaves those two alternatives largely intact.

Prevention or the Ability to Repay. Under the proposed rule, it is an abusive or unfair practice for a lender to make a covered short term loan without reasonably determining the consumer’s ability to repay the loan. *See* Proposed §1041.4. Under the proposed rule, the lender is required to make a good faith determination at the outset of the loan as to whether the consumer has an ability to repay the loan when due, including all associated fees and interest, without reborrowing or defaulting. For each loan, the lender is required to verify the consumer’s net income and major financial obligations through the consumer’s written statement, as well as independent verifying sources. The lender additionally is required to take into account the consumer‘s basic living expenses and review the consumer’s borrowing history from the records of the lender and its affiliates, as well as the consumer’s credit report. *See* Proposed 1041.5(b) and 1041.6(a)(2). There is a rebuttable presumption that a consumer does not have the ability to repay during any period in which the consumer has certain other covered and non-covered loans and for 30 days thereafter. Proposed 1041.6(b). Additionally, a lender would be prohibited from making a covered short-term loan to a consumer who has already taken out three covered short-term loans within 30 days of each other.

Protection or the Principal Payoff Exemption. The “protection” alternative focuses on the consumer’s repayment options and limits the number of short-term loans a consumer may take within a twelve month period. Under this exemption, a lender is not required to assess the consumer’s ability to repay but is required to consider the consumer’s borrowing history. Proposed 1041.7(a). Section 1041.7 allows the lender to make a series of three tapering closed-end loans, of which the initial loan cannot not exceed $500; the second loan cannot be greater than two thirds of the principal amount of the first loan in the sequence; and the third loan cannot not be greater than one third of the principal amount of the first loan in the sequence. The rule additionally restricts the amortization and allocation of payments to principal and interest and prohibits the loans from being secured by the consumer’s vehicle. This alternative is not available if it would result in the consumer having more than six short-term loans during a consecutive 12-month period or being in debt for more than 90 consecutive days on covered short-term loans during a consecutive twelve month period. Proposed 1041.7(c). Lenders using this exemption will be required to provide the consumer with certain mandated, clear, and conspicuous disclosures. Proposed 1041.7(e). Model forms are provided within the proposed rule.

Longer Term Loan Products

The proposed rule not only covers traditional payday loans, but also "longer-term" credit products. Specifically, the rule regulates loans with a duration of more than 45 days that have an all-in APR in excess of 36% (including add-on charges) where the lender can collect payments through access to the consumer's paycheck or bank account or where the lender holds a non-purchase money security interest in the consumer's vehicle. Proposed 1041.3(b)(2). Like short-term loans, the rule offers alternative "prevention" and "protection" approaches and does not vary significantly from the Bureau's initial proposal.

Prevention or the Ability to Repay Option. Similar to short-term loans, this alternative requires the lender to make a good faith determination at the outset of the loan as to whether the consumer has an ability to repay the loan when due, including all associated fees and interest, without reborrowing or defaulting. Proposed 1041.9. As is the case with the short-term loan provisions, the lender is required to determine if the consumer has sufficient income to make the installment payments on the loan after satisfying the consumer's major financial obligations and living expenses. The rule describes "major financial obligations" as being a consumer's housing expense, minimum payments, and any delinquent amounts due under any debt obligation, child support, and other legally required payments. Proposed 1041.9(a)(2). The rule additionally requires the lender, in assessing the consumer's ability to repay, to take into account the possible volatility of the consumer's income, obligations, or basic living expenses during the term of the loan. Proposed Comment 1041.9(b)(2)(i)-2. Similarly, the rule adds additional rebuttable presumptions of unaffordability for longer-term loans. *See generally* Proposed 1041.10.

<u>Protection or Alternative Exemptions</u>. For longer-term loans, the rule provides two exemptions to the ability to repay requirement. Under both exemptions, the loan term must be a minimum duration of 46 days and the loan would be required to fully amortize. The first of these exemptions largely mirrors the National Credit Union Administration ("NCUA") program for "payday alternative loans" and is referred to by the CFPB as the "PAL approach." Specifically, the lender is required to verify the consumer's income and that the loan would not result in the consumer having received more than two covered longer-term loans under the NCUA type alternative from any lender in a rolling six-month term. Additionally, assuming the consumer meets the screening requirements, the lender could extend a loan between $200-$1,000 which had an application fee of no more than $20 and a 28% interest rate cap. Proposed 1041.11.

The second exemption allows the lender to make loans that meet certain structural conditions and is referred to by the CFPB as the "Portfolio approach." Small lenders using this approach will be required to conduct underwriting but would have flexibility to determine what underwriting to undertake subject to the conditions set forth in Proposed 1041.12. Among the conditions, the loan is required to have fully amortizing payments and a term of not less than 46 days nor more than 24 months. Proposed 1041.12. Additionally, the loan cannot not carry a modified total cost of credit of more than 36% excluding a single origination fee of no more than $50 (or that is originally proportionate to the lender's underwriting costs). Proposed 1041.12(b)(5). Additionally, the projected annual default rate on all loans made pursuant to this alternative must not exceed 5% and the lender would be required to refund all origination fees paid by borrowers in any year in which the annual default rate, in fact, exceeded 5%. Proposed 1041.12(d).

Payment Restrictions

All covered loans, whether short-term or longer-term, are subject to certain collection restrictions. As rationale for the restriction, the CFPB has cited to the "substantial risk of consumer harm, including substantial fees and, in some cases, the risk of account closure" which may come if lenders are allowed to collect payment from consumers' checking, savings and prepaid accounts. *See Outline of Proposals under Consideration and Alternatives Considered,* p. 28 (Mar. 26, 2015).

The proposed rule contains two key notice requirements. First, lenders are required to provide at least three business days advanced written notice before any attempt to withdraw payment from a consumer's checking, savings or prepaid account. Prohibited payment transfers are defined broadly and include electronic fund transfers, ACH transfers, and an account holding institution's transfer of funds. Proposed 1041.14(a)(1). The proposed notice requirements are specific and model forms are included within the rule. In general, however, the notice must contain specific transaction-based information including the exact amount and date of the collection attempt, the payment channel through which collection will be attempted, a break down as to how the payment will be applied, the loan balance, and contact information for the lender. Proposed 1041.15.

Secondly, the proposed rule prohibits a lender from initiating a payment transfer from a consumer's account in connection with a covered loan after the lender's second consecutive attempt to withdraw payment has failed for lack of sufficient funds unless and until the lender obtains from the consumer a new and specific authorization to make further withdrawals. Proposed 1041.13.

Compliance Requirements

The rule imposes new reporting, record-keeping, and compliance requirements. In general, the rule requires lenders to furnish information regarding covered loans to all registered information systems which presumably will include the national consumer reporting agencies. *See generally* Proposed 1041.16. The proposed rule requires lenders to furnish particular information about the consumer and the loan throughout the loan's history.

If finalized, the rule will also mandate a 36-month retention period for most records (paper and electronic) relevant to the loan and its history. Section 1041.18(b) requires the lender retain the loan agreement, as well as certain documentation obtained in connection with a covered loan including: the consumer report, verification evidence, written statement of expenses obtained from the consumer and payment authorizations. Additionally, the lender is required to retain certain electronic records in tabular form which document, among other things, the lender's process for determining the consumer's ability to repay the loan, the payment history, and loan performance.

Finally, the rule mandates the establishment of a compliance management system for lenders who choose to make loans covered by the proposed rule. Lenders are required to establish a compliance program that is "reasonably designed to ensure compliance" with the approving and making of covered loans. The rule requires lenders to adopt written policies and procedures appropriate to the size and complexity of the lender and its affiliates, as well as the nature and scope of their covered loan-lending activities. *See* Proposed §1041.18.

Impacts of the Proposed Payday Rule

While there is no doubt there may be need for reform, the proposed rule absolves the consumer of any responsibility for good decision-making and is likely to have two key impacts: (a) make short-term credit harder for consumers to come by, and (b) contract the small lending market. Both of these impacts are acknowledged by the CFPB and are of concern to stakeholders.

Impact on Consumers. In its present form, the rule significantly curtails short-term loans, a fact acknowledged by the CFPB. The CFPB simulations indicate that using the ability to repay option ("prevention"), loan volume is likely to fall between 69-84%. Their simulation, using the alternative option ("protection"), would result in a 55-62% decline in loan volume. *Outline of Proposals under Consideration and Alternatives Considered,* pp. 40-44 (Mar. 26, 2015). These simulations take into account only the more restrictive requirements to qualify for short-term loans and do not take into account the operational impact on lenders (which will be discussed below). The CFPB concedes that as a result, it is likely that "[r]elatively few loans could be made under the ability-to-repay requirement." *Id.,* p. 45. Moreover, [m]aking loans that comply with the alternative requirements…would also have substantial impacts on revenue." *Id.* The CFPB concludes, therefore, that the proposal could lead to substantial consolidation in the market.

Impact on Lenders. In its present form, the proposed rule significantly increases the operational costs involved in making covered loans. Lenders will be required to invest in computer systems and software to comply with the recordkeeping requirements and invest time in developing policies and procedures regarding the new requirements and in training staff. Additionally, the costs in terms of time for making each loan and collecting it will be significant. This is particularly true when taking into account the fairly minimal amount of each loan.

It is important to note that the payday rules have been issued under the CFPB's authority to prevent unfair, deceptive, and abusive practices. While there is no private right of action provided within the rules, it will provide another avenue for litigation as consumer attorneys are likely to boot strap violations of the rules as a violation of state unfair and deceptive trade practice statutes. Moreover, in addition to the aforementioned increase in operational and underwriting costs of making covered loans, the rules will add an additional layer of examination requirements on federal regulators.

Already, stakeholders are expressing serious concerns about the proposed rule. In a recent letter to the CFPB, the Independent Community Bankers and Credit Union National Association indicated that if passed in its present form, the rule "would unquestionably disrupt lending by credit unions and community banks." *Letter to Director Richard Cordray (June 27, 2016).* The letter notes that "[t]he requirements outlined in the proposed rule…are extremely complex and prescriptive, and inconsistent with how credit unions and community banks that know their members and customers underwrite a loan that can be for a relatively small amount of money…subjecting them to a lengthy list of requirements would undoubtedly significantly reduce consumer options for these loan products." *Id.*

Congress has additionally inserted itself into the discussion. The House 2017 Financial Services Bill seeks to delay finalization of the rule until the CFPB submits a detailed report, with public comment, on the consumer impact and identifies existing short-term credit products to replace the current sources of small term, small dollar credit. *Press Release: Appropriations Committee Approves Fiscal Year 2017 Financial Services Bill (June 9, 2016).*

Conclusion

As noted, the comment period for the proposed rule will run through September 14, 2016, and stakeholders should review the proposed rule carefully with counsel and submit comments as appropriate. It is clear that the payday proposed rule has the attention of the legislative branch as well as major stakeholders and it is likely there will be some modifications before a final rule is adopted. When finalized, the CFPB has proposed that the final rule will not take effect under 15 months after publication of the final rule. There appears, therefore, to be a fairly lengthy time period for the industry to ramp up in anticipation of the effective date.

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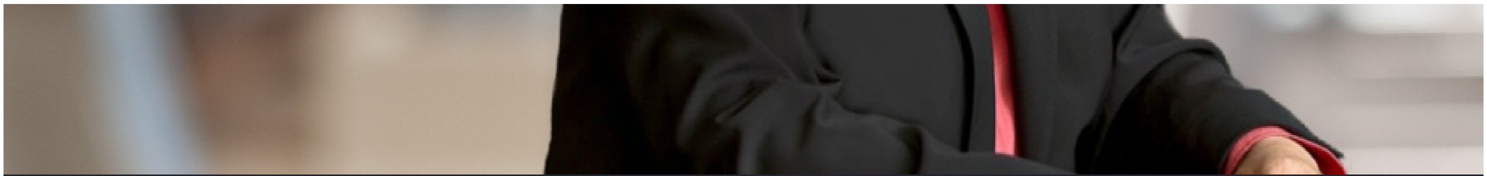

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