Pepper Hamilton LLP
Attorneys at Law

High-Cost Lending at Risk Under CFPB Proposed Rules

CLIENT ALERT | June 16, 2016

Richard P. Eckman | eckmanr@pepperlaw.com
PJ Hoffman | hoffmanp@pepperlaw.com

THE PROPOSED RULE RAISES TROUBLING ISSUES REGARDING THE IMPACT ON SOME TRADITIONAL BANK PRODUCTS AS WELL AS SOME MARKETPLACE LENDING PRODUCTS.

The Consumer Financial Protection Bureau (CFPB or Bureau) released its long-awaited payday lending proposed rule on June 2 as part of a rollout that included a field hearing and all 1,300 pages of the proposed rule. The proposed rule largely echoes the proposals released by the Bureau as part of the Small Business Review Panel in March 2015 (available at http://www.pepperlaw.com/publications/cfpb-proposals-for-small-dollar-loans-an-attempt-to-kill-an-industry-2015-04-09/). The proposal is issued pursuant to the authority granted to the CFPB to determine certain financial products or practices as unfair, deceptive and abusive. In addition to the proposed rule, the CFPB is also launching an inquiry into other potentially high-risk loan products and practices focused on lower-income individuals that are not specifically covered by the proposed rule.

A copy of the proposed rule can be found here (http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf). Comments are due to the Bureau on or before September 14, 2016.

What Is Covered by the Proposal?

The proposal applies to all lenders, including banks, credit unions and nonbanks, such as marketplace lenders, whether brick and mortar or online, that make "covered loans." The covered loans include payday loans, single-payment auto title loans and higher-cost installment loans and open-end lines of credit.

The proposal divides covered loans into two types:

- **Short-term loans:** Loans with a term of 45 days or less.
- **Longer-term loans:** Loans with a term of greater than 45 days that (1) the lender charges a total, all-in annual percentage rate that exceeds 36 percent, including add-on charges and (2) either collects payment through a leverage payment mechanism or secures the loans by holding title to the consumer's vehicle as collateral.
    - A "leverage payment mechanism" is where the lender (1) has the right to initiate a transfer of money through any means, from a consumer account to satisfy an obligation on a loan, (2) has the contractual right to obtain payment from the consumer's employer; or (3) collects through payroll deduction.

What Is Excluded from This Rule?

The proposed rule specifically excludes:

- loans extended to solely finance the purchase of a car or other goods, which secure the loan (this excludes services such as GAP insurance, service plans, etc.)
- home mortgages and loans secured by real property or a dwelling if recorded and perfected
- credit cards
- federal and private student loans

- non-recourse pawn loans
- overdraft services and overdraft lines of credit.

Full-Payment Test

The proposed rule asserts that making a covered loan, either short-term or longer-term, without determining a consumer's ability to repay the loan is an unfair and abusive practice. The ability-to-repay mandate includes a full-payment test that would require lenders to determine, prior to making a loan, that a consumer is able to afford to repay the loan without reborrowing.

The full-payment test would require lenders to determine affordability of the loans to ensure that the borrower will have enough residual income to repay the loan, meet major financial obligations and pay for basic living expenses. Extensive and complex underwriting of each loan applicant is required by having a consumer provide a written statement of his or her income and major financial obligations, which the lender will need to verify. In addition, under the proposed rule, lenders would be required to check a consumer's credit report (a national consumer report and a consumer report from a "registered information system") in order to verify the amount of outstanding loans and payments. Also, lenders would need to include and verify housing expenses and forecast basic living expenses.

For **open-end credit**, lenders must undertake an ability-to-repay analysis on any cash advance in which a previous ability-to-repay analysis has not been conducted within 180 days.

For **short-term loans**, this means lenders would be required to determine if a consumer can meet major financial obligations and basic living expenses during the term of the loan and for 30 days after paying of the loan or the loan's highest payment.

For **longer-term loans with balloon payments**, lenders would be required to ensure a borrower has sufficient residual income to make all of the payments when due, including the balloon payment, and for 30 days after paying the loan's highest payment.

For **longer-term loans without balloon payments**, lenders would be required to ensure a borrower can pay all of the payments when due throughout the term of the loan.

Roll-Over Loans

The proposal would also make it more difficult for lenders to roll over a loan or offer similar loans within 30 days of paying off a loan.

For payday and single-payment auto title loans, the lender is restricted from offering a similar loan as a roll-over loan upon its maturity or within 30 days after paying off a previous short-term debt, unless the financial situation of the borrower materially improves relative to what it was since the prior loan was made. In addition, there would be a maximum of three loans in succession, after which a mandatory 30-day cooling off period would apply.

For longer-term loans, lenders could not refinance the loans into a loan with similar payments unless the financial situation of the borrower materially improves relative to what it was during the prior 30 days. However, the lender could offer to refinance if that would result in smaller payments or lower total cost of credit.

Principal Payoff Option – Closed-End Loans

The proposed rule would allow for a consumer to take out a short-term loan up to $500, without the full-payment test, as part of a principal payoff option. The principal payoff option would bar lenders from taking auto title as collateral or structuring the loan as open-end credit. This option would not be available to consumers who have outstanding short-term or balloon-payment loans or who have been in debt from a short-term loan more than 90 days in a rolling 12-month period. The principal payoff option could only be offered for up to two extensions of the loan and only if the borrower pays off at least one-third of the principal with each extension.

In addition, the principal payoff option would include plain language notice requirements, which must be provided to consumers prior to making a loan.

The Bureau's proposed rule would require lenders to use credit reporting systems to report and obtain information under the full-payment test or the principal payoff option.

Longer-Term Loan Option

The proposal offers two longer-term loan options for lenders.

The first is offering loans that conform to the National Credit Union Administration's "payday alternative loans" program, including interest rates that are capped at 28 percent with an application fee that is $20 or less. The loan principal must be no less than $200 and no more than $1,000, with a term of at least 46 days and no more than six months.

The second option would be to offer loans that have roughly equal payments with a term of two years or less and have an all-in cost of 36 percent or less, not including a reasonable origination fee. The safe harbor of what is “reasonable” is $50. The lender would be required to refund the origination fee in any year that the default rate of the portfolio exceeds 5 percent. Additionally, lenders would be limited in the amount of each type of these loans they could make per consumer per year.

Payment Restrictions

The proposal asserts that the use of what is termed a “leveraged payment mechanism” is an unfair and abusive practice if the lender attempts to withdraw a payment for a covered loan after a second attempt fails for insufficient funds unless the lender provides a notice and follows certain procedures to obtain a new authorization for the payment from the consumer. In addition, there is a written notice requirement, under which a lender would have to give a consumer written notice before attempting to debit the consumer’s account to collect payment for any covered loan. This notice would generally have to be delivered at least three business days prior to the withdrawal attempt and include the timing, amount and channel of the forthcoming payment transfer. If the amount or payment channel is different than the past practices, the notice would also alert the consumer of that change.

Request for Information into Emerging Risks

In addition to the proposed rule, the Bureau also issued a request for information regarding products and practices that are not covered by the proposed rule. The request for information specifically focuses on noncovered loans, such as high-cost, longer-duration installment loans and open-end lines of credit where a vehicle title is not taken as collateral or where the lender cannot gain account access. The practices that the CFPB is seeking to learn more about are those where lenders seize borrower wages, funds, vehicles or other forms of personal property. Additionally, the Bureau is seeking information regarding the sales and marketing practices of credit insurance, debt suspension or debt cancelation agreements, loan churning, default interest rates, teaser rates, prepayment penalties, late-payment penalties, and other add-on products.

A copy of the request for information can be found here (http://files.consumerfinance.gov/f/documents/RFI_Payday_Loans_Vehicle_Title_Loans_Installment_Loans_Open-

End_Credit.pdf). Comments are due to the CFPB regarding this request for information on or before October 14, 2016.

Pepper Points

- The proposed rule raises troubling issues regarding the impact on some traditional bank products because the all-in APR can bring many bank products, including subprime auto title loans and subprime installment loans, as well as some marketplace lending products, such as those offered by Lending Club and Prosper, within the proposed rule's coverage. The likely impact is that marketplace lenders, as well as traditional lenders, will restrict loans to those individuals whose FICO scores entitle them to a loan at an interest rate below 36 percent.

- There are few online lenders that actually offer short-term loans, even before this proposal was issued. There is little doubt, given the complex underwriting that needs to be done on short-term low-dollar loans, that these loans will completely disappear from the marketplace.

- The longer-term loan proposal may be viable for larger lenders that can afford the extensive underwriting that will be required for such loans. Whether larger loan lenders can make profitable loans under the proposal remains to be seen.

- The portfolio loan proposal of offering a 36 percent interest rate plus a $50 origination fee is an interesting one that was not part of the initial Small Business Regulatory Enforcement Fairness Act proposal. Again, this may not present a viable option, given the draconian consequences of exceeding the 5 percent default rate on all covered loans, which will be totally unknown at inception.

- Under the proposal, all longer-term loans without a limitation on term are covered loans if they carry an interest rate of greater than 36 percent. So a 10-year loan with an ACH debit feature at a 37 percent interest rate is a covered loan.

- We believe it is important for lenders to focus on the list of credit products that would be excluded from the definition of "covered loans." It may be possible that marketplace lenders and others will look to use these types of excluded credit products as a means to avoid the restrictions of the proposed rule.

- It remains to be seen if the proposed rule were to be finalized as proposed, whether banks, credit unions and nonbanks would be able to make a profitable short-term lending product or if they will leave this segment of the market altogether. If that is the case, who or what will provide short-term lending in the future? Some would argue it is the post office.

- The request for information signals an even more expansive reach into the products and practices of lenders in the short-term and longer-term lending markets. This signals a future crackdown above and beyond the contemplated proposed rule.

- One of the presumptions of unaffordability is if a borrower expresses an inability to repay. For storefront lenders, this could lead to a “he said, she said” situation, and those lenders may have difficulty recording/documenting that.

- Recordkeeping requirements under the proposed rule are 36 months. Lenders must comply with specific and complex requirements for tabular format. This will require system changes and enhancements that small lenders may find costly.

- Given the length and complexity of the 1,300-page proposed rule, please reach out to members of Pepper Hamilton’s Marketplace Lending team for answers to any additional questions that arise, specifically, Richard P. Eckman, Gregory J. Nowak, Julia D. Corelli, PJ Hoffman or Esuga T. Abaya.