Clients&FriendsMemo

CFPB Proposed Rules Address Payday Loans and Impose New Customer Diligence Requirements

June 8, 2016

The Consumer Financial Protection Bureau ("CFPB") last week announced long-awaited proposed rules governing payday loans and other high-cost credit products, including that lenders must take steps to ensure prospective borrowers have the ability to repay them.[1] The proposed rules, which would apply to both physical and online banks, credit unions, and other lenders regardless of how they are licensed under state law, are the latest effort by the CFPB to exercise its authority under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[2] If approved, they would impose new compliance and recordkeeping obligations on lenders that provide certain types of short- and longer-term loans to consumers.

I. Applicability of Proposed Rules

The driving force behind the proposed rules is the CFPB's position that providing certain types of credit products to consumers without first reasonably determining that the borrower has the ability to repay is an abusive and unfair practice. When consumers of such products are unable to pay, they will likely renew the loan and incur new interest charges, fees and penalties, or default on the loan and suffer adverse financial and credit implications. The result is a "debt trap" from which the CFPB views many consumers are unlikely to recover.

The proposed rules would apply to "covered loans" made to consumers for personal, family, or household purposes, including:

- shorter-term "payday" loans or other credit products that must be substantially repaid within 45 days; or
- longer-term loans whose total cost of credit exceeds 36% per annum and where the lender obtains either:

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

[2] *See* CFPB Policy & Compliance Blog, We've proposed a rule to protect customers from payday debt traps (June 2, 2016), http://www.consumerfinance.gov/about-us/blog/weve-proposed-rule-protect-consumers-payday-debt-traps/.

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- a "leveraged payment mechanism" in the form of the right to withdraw funds from the consumer's bank account, the right to obtain payment directly from the consumer's employer or other source of income, or the right to obtain payment through a payroll deduction; or
- "vehicle security" in the form of a security interest in the consumer's motor vehicle.

Excluded from the definition of covered loans are loans made to finance the initial purchase of a secured good, credit that is secured by real estate, credit cards, student loans, non-recourse pawn loans, overdraft services, and overdraft lines of credit.

II. Customer Ability to Repay Determination

Under the proposed rules, a lender may not issue a covered loan (or increase the credit available under a covered loan) to a consumer without first making a reasonable determination that the consumer will have the ability to make each payment under the loan at the time it is due. Under this "full-payment test," a lender must conclude that the consumer has sufficient income to make all payments under the loan without renewing or extending its terms, and at the same time be able to meet basic living expenses (such as food and utilities) and any major financial obligations (including rent and child support payments) during the loan period and for 30 days thereafter. In making this determination, the lender must obtain from the consumer a written statement of post-tax income receipts and financial obligations, and verify this information from historical income and benefit statements, and obtain a copy of the consumer's credit report.

In addition, a lender may not permit a consumer to renew a shorter-term covered loan within 30 days of paying off a previous debt, unless the lender determines that the consumer's financial situation has "materially improved." The same determination must be made if a consumer sought a second renewal of a shorter-term covered loan. Under no circumstances could a shorter-term covered loan be renewed for a third time – instead, a mandatory 30-day cooling off period must be observed. For longer-term covered loans, a lender may not refinance the loan unless the consumer can make a similar showing that their financial situation during the term of the new loan would be materially improved relative to the previous 30 days.

The proposed rules provide an alternate "principal payoff option" for shorter-term covered loans under $500, allowing the lender to forgo the full-payment test so long as the loan is only extended twice, and in each instance the consumer pays off at least one-third of the loan during each extension period. Lenders would be barred from taking automobile title as collateral for such loans, and such alternate loans could not be offered to consumers who have outstanding shorter-term or balloon-payment loans or have been in debt on shorter-term loans more than 90 days in a rolling 12-month period.

III. Other Restrictions and Compliance Requirements

The proposed rules would require lenders who make covered loans to provide written notice before attempting to secure payment by debiting a consumer's bank account. This notice, which would be provided at least three days prior to the withdrawal attempt, must include the timing and amount of the transaction. After two consecutive unsuccessful attempts, a lender will be required to obtain new authorization from the consumer before attempting to access the account.

Lenders will also be required to draft and implement risk-based written policies and procedures to address compliance with the proposed rules. All loan agreements and documentation of compliance (such as consumer income and expense verification and credit reports) must be retained for 36 months after the date a covered loan is repaid. In addition, since lenders will be required to use credit reporting systems to obtain consumer information and report on covered loans issued, they will be considered consumer reporting companies under the Fair Credit Reporting Act[3] and will be required to register with the CFPB.

IV. Conclusion

The CFPB's proposed rules governing payday loans are instructive for several reasons. First, they illustrate a clear view by the CFPB that payday lenders are taking advantage of an economically vulnerable population and need to be seriously curtailed. By limiting the numbers of renewals available to consumers – and significantly increasing the compliance burden, reporting and recordkeeping obligations, and costs associated with providing such loans – the proposed rules will have a serious impact on the ability of payday lenders to provide these products to consumers. Second, the proposed rules are a clear attempt by the CFPB to further influence the financial services industry through new legal and compliance obligations. Coming on the heels of the CFPB's actions to preserve consumers' ability to join class actions against lenders,[4] the proposed rules signal likely future scrutiny of other high-cost longer-term credit products, credit insurance agreements, and common practices of lenders including teaser interest rates, prepayment penalties, and late-payment penalties. The proposed rules are the latest effort by the CFPB to assert its widespread consumer protection authority under Dodd-Frank, and certainly will not be its last.

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[3] 15 U.S.C. § 1681 *et seq*, *available at* https://www.ftc.gov/enforcement/rules/rulemaking-regulatory-reform-proceedings/fair-credit-reporting-act.

[4] Last month, the CFPB proposed rules that would effectively prevent the use of arbitration clauses by certain financial services providers to block consumers from participating in class action lawsuits. *See* Cadwalader Clients & Friends Memo, *CFPB Targets Mandatory Arbitration Clauses to Protect Consumer Class Actions* (May 10, 2016), http://www.cadwalader.com/resources/clients-friends-memos/cfpb-targets-mandatory-arbitration-clauses-to-protect-consumer-class-actions.

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