CFPB Releases its Proposed Rule to “End Debt Traps”

This American Financial Services Association (“AFSA”) White Paper is a summary analysis of the Notice of Proposed Rulemaking on Payday, Vehicle Title and Certain High-Cost Installment Loans (the “Proposal”), released June 2, 2016. It is designed to explain the Proposal’s impact on Traditional Installment Lenders (“TILs”). It does not address the Proposal’s impact on other creditors such as banks, credit unions, payday and title pledge lenders. Further, we do not address Covered short-term loans, as AFSA members generally do not make the same. In the interest of speed and efficiency, the task has been divided by subject matter, as follows:

- What constitutes a Covered longer-term loan?
- How is the ability to repay determined and what is included in the “full payment” test for Covered longer-term loans?
- What are the two alternative options to the “full payment” test available for Covered longer-term loans?
- What restrictions are imposed on renewals and refinancing?
- What requirements are set forth for repayment?
- What are the record keeping requirements?
- What are other substantive restrictions?
- What else is the Bureau asking for in the Proposal?

A more in-depth analysis will be offered by AFSA within the next several days and weeks.

A. What constitutes a Covered longer-term loan?

1. Covered longer-term loans are those with a contractual duration longer than 45 days and the total cost of credit (an “all in” annual percentage rate) exceeds the rate of 36 percent, where the lender holds either (i) access to repayment through a “leveraged payment mechanism” (e.g., ACH of consumer’s checking account or paycheck), or (ii) “vehicle security.”

   a. Vehicle security means a non-purchase money security interest in the consumer’s vehicle.

   b. Leveraged payment mechanism means the ability or contractual right to access the borrower’s funds by initiating an ACH, RCC or similar technique, or obtain payment directly from a borrower’s employer.

      i. provided, however, such ability or contractual right is exercised at the same time as, or within 72 hours after the borrower receives the entire amount of funds that she is entitled to receive under the loan.

   c. There is a sub-category for Covered longer-term balloon-payment loans as well that we do not address here as most TILs do not make balloon payment loans.

   **PRACTICE POINTER: Unlike under the Military Lending Act Regulation, there is no 180 day limitation applicable to vehicle security.**
2. The Proposal does not apply to purchase money consumer product loans, loans secured by real property, credit cards, student loans, non-recourse possessory pawn loans, overdraft services and lines of credit.

3. The proposed rule would make it an unfair and abusive practice for a lender to make a Covered longer-term loan or increase the credit available under such, unless the lender first makes a reasonable determination that the consumer will have the ability to repay the loan.

4. The Rule provides two alternative options that a lender may use without conducting the full payment, ability-to-repay determination.

B. How is the ability to repay determined and what is included in the “full payment” test for Covered longer-term loans?

1. To determine a consumer’s ability to repay the lender must reasonably conclude that:

   a. The consumer’s residual income will be sufficient for the consumer to make all payments under the loan and to meet basic living expenses during the term of the loan; and

   b. Special rule for loans with balloon payments: must determine that consumer can make payments for major financial obligations, meet basic living expenses, etc., for 30 days after having made the highest payment under the loan on its due date.

2. As a result, the lender must make a “reasonable projection of the amount and timing of a consumer’s net income and payments for major financial obligations.”

   a. Must obtain written statement of borrower as to:
      i. Amount and timing of net income receipts; and
      ii. Amount and timing of payments required for categories of major financial obligations.

   PRACTICE POINTER: This appears similar to the “household budget” requirements imposed by some state laws, but something that will be unique to CFPB examination and supervision, and subject to further CFPB interpretation. This requirement does not exist under any other Federal law, not even for mortgage underwriting.

   b. Must obtain evidence verifying written statement:
      i. For income: reliable record of an income payment covering sufficient history to support the lender’s projection;
      ii. For required payments under debt obligations: a credit report from a nationwide consumer reporting agency, the records of the lender and its affiliates, and a consumer report from a “registered information system” (i.e., a specialty credit bureau registered with the CFPB for this purpose);
      iii. For child support: a credit report from a nationwide consumer reporting agency; and
      iv. For housing expenses:
         (a) Lease,
         (b) Reliable records of recent housing expense payments, or
         (c) An estimate based on local housing expenses.

   PRACTICE POINTER: These verification requirements permit lenders to use commercially available databases, modeled or estimated data, and other electronic methods to comply.
c. May only rely on the written statement to the extent that it is consistent with the verification
evidence.
i. Lender may consider other reliable evidence obtained from or about the consumer.
ii. Lender may project a higher amount of income or a lower amount of expenses only if
   the lender obtains from the payor of the income or the payee of the obligation a written
   statement of the amount and timing of the new or changed income or payment.

3. Definitions

a. Basic living expenses means expenses for goods and services necessary to maintain health,
welfare and ability to produce income of consumer and his or her household.

b. Major financial obligations = housing expense + minimum payments on debt obligations + court-
   ordered child support.


d. Net income – gross income less taxes and voluntary contributions.

e. Residual income – net income, less amounts payable for major financial obligations.

C. What are the two alternative options to the “full payment” test available for Covered longer-term
loans?

1. Loans that are similar to NCUA “payday alternative” loans.

a. The ability to repay requirements do not apply to certain Covered longer-term loans, closed-end
   fully amortizing, with terms of not more than six months and principal not less than $200 and not
   more than $1000, meeting the following qualifications:

b. Repayable in two or more substantially equal payments due no less frequently than monthly in
   equal intervals, that carry a total cost of credit of not more than 28% APR with a $20 maximum
   origination fee;

c. the Borrowing history limitation of no more than three outstanding loans made by the lender (or
   affiliates) within the last 180 days;

d. proof of recurring income;

e. the loan does not impose a prepayment penalty or have certain other creditor enhanced
   remedies; and

f. the lender must furnish information concerning the loan to registered information systems or
   nationwide credit reporting agencies.

PRACTICE POINTER: Federally chartered credit unions are subject to the NCUA limitations, and very
few have been able to profitably extend credit under the NCUA program. Some state-chartered credit
unions, which are not subject to the NCUA requirements, extend small dollar credit, but at rates that
are much higher than those permitted under the NCUA limits.
2. Loans with a total cost of credit or 36% APR or less, plus a reasonable origination fee, and a portfolio default rate of less than 5%.
   
a. The ability to repay requirements do not apply to certain Covered longer-term loans, closed-end fully amortizing, with terms of not more than 24 months, meeting the following qualifications:
   
b. Repayable in two or more substantially equal payments due no less frequently than monthly in equal intervals, that carry a modified total cost of credit of less than or equal to an annual rate of 36 percent, such modified total cost of credit excludes the calculation of a single origination fee;
   i. The origination fee must be a reasonable approximation of the lender’s actual costs to originate the loan, but the Proposal would provide a “safe harbor” for fees that are $50 or less.
   
c. The Borrowing history limitation of no more than two outstanding loans made by the lender (or affiliates) within the last 180 days;
   
d. Lender’s portfolio default rate must be less than or equal to 5 percent per year and lender must have policies and procedures in place to address this determination;
   i. The portfolio default rate must be measured annually, and where the rate is determined to exceed 5%, the lender is required to refund all collected origination fees.
   
e. The loan does not impose a prepayment penalty or have certain other creditor enhanced remedies; and
   
f. The lender must furnish information concerning the loan to registered information systems or nationwide credit reporting agencies.

D. What Restrictions are imposed on renewals or refinancing (“reborrowing”) under the Proposal?

1. Renewing or refinancing under the Proposal is addressed in the “additional limitations on lending” sections of the Proposal.

2. Covered longer-term loan limitations on reborrowing:
   
a. With certain exceptions, a consumer is presumed not to have the ability to repay a Covered longer-term loan, rendering the same “unaffordable,” and therefore cannot reborrow, if
   i. The consumer is or has been delinquent by more than seven days within the past 30 days on a scheduled payment on the outstanding loan;
   ii. The consumer expresses or has expressed within the past 30 days an inability to make one or more payments on the outstanding loan;
   iii. The time period between consummation of the reborrowing and its first payment due date would be longer than the time period between consummation of the reborrowing and the next regularly scheduled payment on the existing loan; or
   iv. The reborrowing would result in the consumer receiving no disbursement of loan proceeds or an amount of funds as disbursement that would not substantially exceed the amount of payment or payments that would be due on the existing loan within 30 days of consummation of the reborrowing.
   
b. Exception to presumption of unaffordability:
   i. The lender may offer the reborrowing if that would result in substantially smaller payments or would substantially lower the total cost of the consumer’s credit.
c. Overcoming the presumption of unaffordability:
   i. The consumer has had sufficient improvement in financial capacity such that the consumer will have the ability to repay the reborrowing according to its terms despite the unaffordability of the existing loan.
      (a) This does not apply to making a Covered longer-term loan to pay off an existing Covered short-term loan.

d. There are conditional exemptions for certain Covered longer-term loans (discussed in C1 and C2 above). If the conditional exemption is applicable, then reborrowing will be evaluated under the conditional exemptions section discussed above.

E. What requirements are set forth for repayment for Covered longer-term loans?

The full-payment test requires the lender to determine upfront that the consumer can afford to repay the loan without reborrowing.

a. And, that the borrower has sufficient income to afford the loan and meet the consumer’s major financial obligations and still pay basic living expenses, like food and utilities. These requirements are achieved by:
   i. Verification from employment, government benefits or other sources/
   ii. Check the consumer’s credit report to verify the amount of outstanding loans and required payments thereunder.

b. If the Covered longer-term loan includes a balloon payment, then the test includes a 30-day time period after paying the loan’s highest payment.

c. If the Covered longer-term loan does not include a balloon payment, the test does not extend for the extra 30 days.

F. What are the Record Keeping Requirements?

1. Lender compliance program. A lender making a covered loan must develop and follow written policies and procedures that are reasonably designed to ensure compliance with the requirements in Part 1041. These written policies and procedures must be appropriate to the size and complexity of the lender and its affiliates, and the nature and scope of the covered loan lending activities of the lender and its affiliates.

2. Record retention. A lender must retain evidence of compliance with Part 1041 for 36 months after the date on which a covered loan ceases to be an outstanding loan. Specifically, a lender must retain or be able to reproduce an image of the loan agreement and documentation obtained in connection with a covered loan, including consumer report information, verification evidence, any written statement obtained from the consumer, and any authorization of payment transfer.

3. Electronic record retention. A lender must retain specified electronic records in tabular format regarding each of the following categories: Origination calculations and determinations for ability to repay determinations for covered short-term loans and covered longer-term loans, consumers who qualify for exceptions to or overcome presumptions of unaffordability, loan type and terms, payment history and loan performance.
G. What other substantive provisions are part of the Proposal?

1. Lenders employing the leveraged payment mechanism, at a 36% cost of credit, and therefore making Covered longer-term loans, are subject to additional restrictions including the obligation to give consumers written notice before attempting to debit the consumer’s account to collect payment for any Covered Loan after an attempt to withdraw payment has failed. After two unsuccessful attempts, the lender would be prohibited from debiting the account again absent new and specific authorization from the borrower. There are also disclosure obligations. Violation of these substantive provisions constitutes a UDAAP by the lender.

   a. Lenders that employ ACH or its equivalent following the 72 hour blackout period, who do not take vehicle security, and therefore not making Covered longer-term loans, are not subject to this requirement. However, there is language in the Commentary that raises red-flags associated with any creditor relying on the 72 hour blackout period.

2. The Proposal introduces the concept of a nationwide registration information system to create a comprehensive record of a consumer’s recent and current borrowing. Before making most covered loans, a lender would be required to obtain and review a consumer report from a registered information system.

3. Lenders will be required to establish and follow a compliance program and retain certain records.

4. Lenders will be required to develop and follow written policies and procedures that are reasonably designed to ensure compliance with the Proposal.

5. Lenders will be required to retain the loan agreement documentation and electronic records in tabular format regarding origination calculations and determinations for a Covered Loan, for a consumer who qualifies for an exception to or overcomes a presumption of unaffordability for a Covered Loan.

H. What else is the Bureau asking for in the Proposal? The CFPB is seeking information about:

1. forms of non-Covered Loans including traditional installment loans and open-end lines of credit, including information as to pricing, underwriting practices, and loan structures that include little to no principal reduction for an extraordinary period of time;

2. recovery methods of lenders, including garnishments and repossessions;

3. marketing practices of credit insurance, debt cancellation agreements, GAP waivers, debt suspension and other add-on products.

4. default interest rates, teaser rates repayment penalties and late-payment penalties.