

Client Update

CFPB Finalizes Rule on Payday Lending

On October 5, 2017, the Consumer Financial Protection Bureau (“CFPB”), pursuant to its unfair, deceptive and abusive acts or practices (“UDAAP”) rulemaking authority under the Dodd-Frank Act,¹ issued a final rule (“Final Rule”) to establish consumer protections for payday loans, auto title loans, deposit advance products and certain high-cost installment loans.² The Final Rule prescribes underwriting standards requiring lenders to complete an ability-to-repay determination for each loan provided to a borrower, and also restricts a lender’s ability to make repeated attempts to withdraw payment from a customer’s bank account in connection with a covered loan. In addition, the Final Rule creates registration, notification, recordkeeping and compliance requirements for lenders, designated as “registered information systems.”

The Final Rule will be effective twenty-one months from the date of publication in the Federal Register, or roughly July 2019, with the exception of the registered information systems requirement under Section 1041.11 of the Final Rule, which will be effective sixty days from publication, or roughly December 2017.

In this Client Update, we first provide an overview of the purpose and scope of the Final Rule. We then discuss the Final Rule’s ability-to-repay requirements, payment transfer limitations and registered information systems requirements. Next, we assess the potential impact and the scope of the Final Rule.

PURPOSE AND SCOPE OF THE FINAL RULE

The Final Rule follows much of the substance and scope of the CFPB’s proposed rule (“Proposed Rule”), which was published in the Federal Register on July 22, 2016.³ As the CFPB has indicated

¹ 12 U.S.C. § 5531(b).

² Final Rule, Payday, Vehicle Title, and Certain High-Cost Installment Loans (Oct. 5, 2017), available at https://www.consumerfinance.gov/documents/5666/201710_cfpb_final-rule_payday-loans-rule.pdf; 12 C.F.R. 1041.

³ Proposed Rule, Payday, Vehicle Title, and Certain High-Cost Installment Loans, 81 Fed. Reg. 47864 (July 22, 2016).

in numerous reports and statements, the Final Rule is intended to protect consumers from the debt traps inherent in short-term high-cost loans. In a press call the same day the Final Rule was issued, CFPB director Richard Corday cited the “basic principle of requiring lenders to determine upfront whether people can afford to repay their loans” and the necessity of bringing about market reforms in areas where “too often lenders have succeeded by setting borrowers up to fail.”⁴

On this basis, the Final Rule defines a “Covered Loan” as being closed-end or open-end credit extended to a consumer primarily for personal, family or household purposes, subject to certain conditions. Specifically, for closed-end credit, the Final Rule provides that a Covered Loan includes:

- Closed-end loans where the consumer must repay substantially the entire amount of the loan within 45 days from the date of the loan; or
- Closed-end loans, such as a longer-term balloon payment loan, where the consumer is required to repay substantially the entire balance of the loan in a single payment more than 45 days from the date of the loan, or otherwise repay the loan through one payment that is more than twice as large as any other payment.

For all other loans, the Final Rule considers a Covered Loan to include:

- Loans where the consumer must repay substantially the entire amount of any advance within 45 days of that advance; or
- Loans with multiple advances, where the consumer is required to repay substantially the entire amount of an advance in a single payment more than 45 days after the date of the advance, or otherwise repay the advance through one payment that is more than twice as large as any other payment; or
- Loans with multiple advances, which are structured in a manner such that “paying the required minimum payments may not fully amortize the outstanding balance by a specified date or time, and the amount of the final payment to repay the outstanding balance at such time could be more than twice the amount of other minimum payments under the plan.”

Finally, the Final Rule covers any other loan, like a high-cost installment loan, that exceeds an interest rate of 36%. This determination is made at the time of origination for a closed-end loan or, for open-end credit, at the time of origination and, if not 36% at that time, again at the end of each billing cycle. In addition, the Final Rule requires a “leveraged payment mechanism,” whereby the lender can obtain repayment through direct access of a consumer’s bank account or

⁴ Press Release, Bureau of Consumer Financial Protection, CFPB Finds Four Out of Five Payday Loans are Rolled Over or Renewed (Mar. 25, 2014), <https://www.consumerfinance.gov/about-us/newsroom/cfpb-finds-four-out-of-five-payday-loans-are-rolled-over-or-renewed/>.

payroll. Some industry participants have argued that, by imposing these obligations, the CFPB effectively is imposing a usury limit in violation of Section 1027(o) of the Dodd-Frank Act's prohibition on the agency setting such a limit on extension of credit.⁵ To mitigate these concerns, the Final Rule limits the definition of a covered longer-term loan to focus primarily on the leveraged payment mechanisms, rather than vehicle security, as was considered in the Proposed Rule. Further, the CFPB stresses that "nothing in this rule should be construed as annulling or even as inconsistent with a regulatory or policy approach to such loans based on usury caps, which are wholly within the prerogative of the States to lawfully impose."

Despite the broad coverage of the Final Rule, it does exclude certain types of loans, including non-recourse pawn loans, student loans, credit cards, overdraft lines of credit and no-cost advances, focusing the Final Rule on loans that the CFPB deems to create debt traps for borrowers. In contrast to the Proposed Rule, the Final Rule does not include the ability-to-repay determination requirements for certain longer-term loans, although the CFPB has indicated that it plans to finalize a regulation including such a requirement at a later date.

ABILITY-TO-REPAY DETERMINATION

The Final Rule identifies as an unfair and abusive practice a lender's making of a covered short-term or longer-term balloon-payment loan without reasonably determining that a borrower will be able to repay the loan according to its terms.

In order to protect consumers from debt traps, the Final Rule prescribes certain underwriting standards.⁶ Before a lender may offer a covered loan to a prospective borrower, the lender must have made a reasonable determination that the loan satisfies either the "full-payment test" or the "principal-payoff option," depending on the nature and term of the loan.

Full-Payment Test and Principal-Payoff Options

- The "full-payment test" requires a lender's upfront determination that a borrower can afford to repay the loan in full, without re-borrowing. To satisfy the test, a lender must determine that a borrower will be able to make all payments under the loan and meet basic living expenses and major financial obligations over the term of the loan and for the succeeding 30 days.⁷
- The "principal-payoff option" is an alternative to the full-payment test, available for short-term loans up to \$500 that are structured to allow borrowers to repay gradually.⁸ Lenders

⁵ 12 U.S.C. § 5517(o).

⁶ Final Rule, 12 C.F.R. 1041.5(b).

⁷ Final Rule, 12 C.F.R. 1041.5(b)(i)-(ii).

⁸ Final Rule, 1041.6(b)(1)-(4).

may offer up to two payment extensions if the borrower pays off at least one-third of the principal each time. Lenders may offer a maximum of three such loans in a sequence and may not offer loans under this provision to borrowers with more than six short-term loans outstanding or with outstanding debt on covered short-term loans for more than 90 days in aggregate.⁹

- As noted above, in contrast to the Proposed Rule, the Final Rule does not include an underwriting requirement for covered longer-term loans without a balloon payment; however, such loans are nevertheless subject to the payment transfer restrictions discussed below.

DEBIT ATTEMPT CUTOFF

The Final Rule also identifies it as an unfair and abusive practice for a lender to make attempts to withdraw payment from a consumer's account in connection with a Covered Loan after two consecutive attempts have failed due to lack of sufficient funds, unless the lender receives new and specific authorization from the borrower to make further withdrawal attempts from the account.¹⁰ This aspect of the Final Rule appears to be motivated by the CFPB's concern about repeated overdraft fees incurred by consumers due to repeated failed attempts at payment withdrawal.

Payment Withdrawal Restrictions

- The prohibition on payment withdrawals applies to all Covered Loans under the Final Rule, including short-term loans, balloon-payment loans and longer-term loans with annual percentage rate over 36%.
- Lenders are first required to provide borrowers with written notice prior to debiting the borrower's account to collect payment on a Covered Loan. Under the Final Rule, the written notice must include the date on which the transfer will occur, the dollar amount to be transferred, the account from which that amount will be transferred, identification of the loan and certain other information regarding the format in which the transfer will occur.
- A lender may initiate additional payment transfer attempts after two consecutive payment transfer attempts have failed only with the consumer's specific and new authorization of the transfer, including the specific date, amount and authorized payment channel of the additional payment.¹¹ Such specific authorization must be signed, in writing, or otherwise formally memorialized.¹²

⁹ Final Rule, 12 C.F.R. 1041.6(c)(1)-(3).

¹⁰ Final Rule, 12 C.F.R. 1041.7.

¹¹ Final Rule, 12 C.F.R. 1041.8(c).

¹² Final Rule, 12 C.F.R. 1041.8(c)(3).

REGISTERED INFORMATION SYSTEMS

The Final Rule also provides for the registration of consumer reporting agencies to which lenders are required to furnish information concerning Covered Loans at intervals throughout the lifetime of the loan.¹³

- Information subject to the furnishing requirement may include information necessary to uniquely identify the loan, loan consummation date, principal amount borrowed, minimum amount of payment due and due date for each loan payment.¹⁴ The Final Rule further requires that lenders must obtain consumer reports for use in making credit determinations for Covered Loans.
- The Final Rule contemplates that such information systems will be functional at the time the lenders' reporting obligations take effect.¹⁵

POTENTIAL REGULATORY IMPACTS

The Final Rule could have a broad impact on a variety of consumer finance lending companies, including online marketplace lenders to the extent that they are engaged in providing Covered Loans to consumers. While the Final Rule seeks to mitigate significant risks that the CFPB sees in the market, it will almost certainly also have the effect of restricting consumer access to credit. In particular, one of the benefits of payday loans and related products is that they can be approved quickly and permit borrowers to receive funds for a limited period of time. The underwriting requirements of the Final Rule, including the requirement that a lender obtain a consumer report before making a loan, will significantly extend the approval timeline for a loan. Thus, the Final Rule may materially shift whether and how borrowers can gain access to short-term funds and also change the characteristics of borrowers eligible to receive such funds. Even if borrowers turn to other outlets to attempt to access credit, the Final Rule will likely have unintended impacts, including an increase of debt collection activities, bankruptcies, negative consumer reporting information, and a potential chilling of new, innovative product offerings.

Further, the industry has expressed concern that profits in the short-term lending industry may decrease dramatically as a result of the Final Rule, resulting in steep losses for smaller industry participants.¹⁶ The Final Rule's underwriting requirements will likely increase costs to lenders, while also limiting the number of loans extended based on ability-to-repay requirements.

¹³ Final Rule, 12 C.F.R. 1041.10(c).

¹⁴ Final Rule, 12 C.F.R. 1041.10(c)(1)(i)-(viii).

¹⁵ Final Rule, 12 C.F.R., 1041.11(c).

¹⁶ See e.g., Charles River Associates, *Economic Impact on Small Lenders in the Payday Lending Industry under Consideration by the CFPB* (May 2015), available at <http://www.crai.com/sites/default/files/publications/Economic-Impact-on-Small-Lenders-of-the-Payday-Lending-Rules-under-Consideration-by-the-CFPB.pdf>.

Nevertheless, one considerable win for the industry is the CFPB's reversal of its proposal to impose ability-to-repay requirements on longer-term loans. As a result, smaller lenders and other creditors in the industry may shift toward the provision of such longer-term loans to borrowers.

Based on the potential contraction of the market, borrowers may turn to other forms of credit, including less well-regulated methods of short-term credit. These could include other areas the CFPB has focused on in the past, such as deferred-interest credit cards, no-cost advances and overdraft lines of credit, as well as longer-term, higher-cost installment loans. Another option for these borrowers could include marketplace loans, where certain lenders are already assessing ability-to-repay using alternative measures during the underwriting process.¹⁷

Borrowers may also pursue shorter-term loans provided by community banks and credit unions, or deposit advance products offered by national banks and other financial institutions. This possibility has been further fostered by the Office of the Comptroller of the Currency's ("OCC") rescission of its 2013 supervisory guidance covering deposit advance products and accompanying OCC Bulletin 2013-40. In rescinding this guidance, the OCC cited overlap and potential inconsistencies that could be created by the application of the Final Rule to national banks and federal savings associations.¹⁸ Acting Comptroller of the Currency Keith Noreika noted in a statement approving the rescission that in the years since this guidance was issued, banks have faced increasing difficulty meeting consumers' needs for short-term, small-dollar credit, which has caused consumers to seek out "lesser regulated entities...result[ing] in consumer harm and expense."¹⁹ The OCC's rescission is a clear sign that the OCC plans to take a different approach than the CFPB on short-term small-dollar lending, which may benefit banks that engage in such lending.

It remains to be seen if the Final Rule will take effect and create these potential impacts. Two events could impede its implementation: (1) the departure of CFPB Director Richard Cordray at the end of his term next July (and rumors that he may leave sooner to run for office in the State of Ohio); and (2) Congress's ability to reverse the Final Rule under the Congressional Review Act. While the next Director may limit enforcement of the Final Rule, or take steps to

¹⁷ See CFPB, No Action Letter to Upstart (Sept. 14, 2017), available at <https://www.consumerfinance.gov/about-us/newsroom/cfpb-announces-first-no-action-letter-upstart-network/>.

¹⁸ Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance Products, 78 Fed. Reg. 70624 (Nov. 13, 2013); OCC Bulletin 2013-40 "Deposit Advance Products."

¹⁹ Press Release, Office of the Comptroller of the Currency, Acting Comptroller of the Currency Rescinds Deposit Advance Product Guidance (Oct. 5, 2017). <https://www.occ.gov/news-issuances/news-releases/2017/nr-occ-2017-118.html>.

reconsider the need for the regulation, Congress is unlikely to move forward on a reversal of the Final Rule, particularly in light of its record with regard to other recent CFPB regulations.²⁰

CONCLUSION

The regulation of payday lending is not an entirely new phenomenon, although payday lending regulation until now had been largely left to the states. While the industry anticipated the comprehensive scope of the Final Rule, the CFPB's decision to finalize the regulation, particularly given the current legislative and regulatory push to ease federal oversight related to banking and consumer finance companies, indicates that the agency is continuing to pursue its agenda despite the overall political and regulatory environment.

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Please do not hesitate to contact us with any questions.

²⁰ Stacy Cowley, *Payday Lending Faces Tough New Restrictions by Consumer Agency*, (Oct. 5, 2017), available at <https://www.nytimes.com/2017/10/05/business/payday-loans-cfpb.html>.

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