Insights

CFPB Issues Final Payday and Installment Loan Rule

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The Consumer Financial Protection Bureau (the “CFPB” or the “Bureau”) released their Payday, Vehicle Title and Certain High Cost Installment Loans Rule (the “**Final Rule**”) on October 5, 2017. While the Final Rule is primarily aimed at the payday and vehicle title loan industry, it will also impact traditional installment lenders who make loans with a finance charge in excess of thirty-six percent (36%) that use a “leveraged payment mechanism” (“LPM”). This Client Alert will provide a brief summary of the Final Rule's key provisions, including:

I. **Scope and Key Definitions**
II. **Requirements For Lenders Making Covered Loans**
III. **Safe Harbor For Qualifying Covered Loans**
IV. **Payments**
V. **Recordkeeping, Reporting And General Compliance Burdens**

EXECUTIVE SUMMARY

The Final Rule adds 12 CFR part 1041 to Chapter X in Title 12 of the Code of Federal Regulations, effectively eliminating the payday lending industry as it currently exists by subjecting all loans with a term of less than forty-five (45) days (a “Covered Short-Term Loan”), to a detailed underwriting standard, restrictions on the use of LPM ‘s, added consumer disclosures, and significant reporting requirements exposing short term lenders to unprecedented regulatory scrutiny. Violations of the new underwriting and LPM standards are considered unfair and abusive practices under the Consumer Financial Protection Act (the “CFPA”).[1] It is anticipated the payday lending industry will have no choice but to transition its business model to appear more like that of higher rate installment lenders in response.

The Final Rule makes it an abusive and unfair practice for a lender to:

- Make a covered short-term loan, a covered longer-term loan, or a covered longer-term balloon loan (collectively referred to as a “Covered Loan”), without reasonably determining that the consumer has the ability to repay the loan; or

- Attempt to withdraw payment from a consumer’s account in connection with a Covered Loan after the lender’s second consecutive attempt to withdraw payment from the account has failed due to a lack of sufficient funds, unless the lender obtains the consumer’s new and specific authorization to make further withdrawals from the account.

For traditional installment lenders, the Final Rule represents a marked improvement from the **Proposed Rule** by limiting its scope to apply only to loans with a "cost of credit" calculated in compliance with Regulation Z that also use a LPM. The use of this "traditional" APR definition linked to the often used 36% trigger rate, especially when coupled with the requirement that a LPM be used, is expected to see the traditional installment lending industry continue with minimal disruption; however, the CFPB indicated in the Final Rule that they will consider the applicability of the more encompassing Military Lending Act definition of cost of credit to longer-term loans in a subsequent rule.

THE DETAILS

I. Scope and Key Definitions

A. Scope

If your institution offers a consumer loan that meets the definitional standards discussed below, regardless of the state usury laws in your state, you will be required to comply with the added requirements for a Covered Loan. There are limited exclusions from the scope of the Final Rule for the following types of loans:

Excluded Loans

- Purchase money security interest loans;
- Real estate secured credit;
- Credit cards;
- Non-recourse pawn loans;
- Overdraft services and lines of credit;
- Wage advance programs; and
- No cost advances.

B. Key Definitions

Covered Loan - is a closed-end or open-end loan extended to a consumer primarily for personal, family, or household purposes, that is not considered exempt. There are three categories of Covered Loans:

Covered Short-Term Loans (traditional payday loans) - loans with a duration of forty-five (45) days or less.[2]

Covered Longer-Term Balloon Payment Loans – loans where the consumer is required to repay substantially the entire balance of the loan in a single payment, or to repay the loan though at least one payment that is more than twice as large as any other payment, more than 45 days after consummation.

Covered Longer-Term Loans - loans with a duration of more than forty-five (45) days[3] extended to a consumer primarily for personal, family or household purposes if the "cost of credit" exceeds thirty-six percent (36%) per annum and the creditor obtains a "leveraged payment mechanism."

Leveraged Payment Mechanism - The Final Rule defines a Leveraged Payment Mechanism as the right to initiate a transfer of money, through any means, from a consumer's account to satisfy an obligation on a loan, except when initiating a single immediate payment transfer at the consumer’s request.

II. Requirements for Lenders Making Covered Loans

A. Underwriting Requirements

The Final Rule generally provides that it is an unfair and abusive practice for a lender to make a covered short-term loan or covered longer-term balloon-payment loan, or increase the credit available under a covered short-term loan or covered longer-term balloon payment loan, unless the lender first makes a reasonable determination that the consumer will have the ability to repay the loan according to its terms.[4]

The Final Rule provides that a lenders determination that a consumer can repay a covered short-term loan or a covered longer-term balloon loan is reasonable only if either:

- Based on the calculation of the consumer’s debt to income ratio for the relevant monthly period and the estimates of the consumer’s basic living expenses[5] for the monthly period, the lender reasonably concludes that:
  - For a covered short-term loan, the consumer can make payments for major financial obligations,[6] make all payments under the loan, and meet basic living expenses during the shorter of either the term of the loan or the period ending 45 days after consummation of the loan, and for 30 days after having made the highest payment under the loan; and
  - For a covered longer-term balloon-payment loan, the consumer can make payments for major financial obligations, make all payments under the loan, and meet basic living expenses during the relevant monthly period, and for 30 days after having made the highest payment under the loan.

OR

- Based on the calculation of the consumer’s residual income[7] for the relevant monthly period and the estimates of the consumer’s basic living expenses for the relevant monthly period, the lender reasonably concludes that:
  - For a covered short-term loan, the consumer can make payments for major financial obligations, make all payments under the loan, and meet basic living expenses during the shorter of the term of the loan or the period ending 45 days after consummation of the loan, and for 30 days after having made the highest -payment under the loan; and
  - For a covered longer-term balloon-payment loan, the consumer can make payments for major financial obligations, make all payments under the loan, and meet basic living expenses during the relevant monthly period, and for 30 days after having made the highest payment under the loan.

Limited Exemption

There is a limited exemption for certain covered short-term loans from the ability to repay and unfair and abusive practice provisions of the Final Rule for short term loans with the following features:[8]

- The principal amount of the loan is at or below the following principal limitations:

- For the first loan in a loan sequence of covered short-term loans made under this section, the principal amount is no greater than $500;
- For the second loan in a loan sequence of covered short-term loans made under this section, the principal amount is no greater than two-thirds of the principal amount of the first loan in the loan sequence;
- For the third loan in a loan sequence of covered short-term loans made under this section, the principal amount is no greater than one-third of the principal amount of the first loan in the loan sequence;

- The loan amortizes completes during the loan term and the payment schedule provides for allocating a consumer's payments to the outstanding principal and interest and fees as they accrue only by applying a fixed periodic rate of interest to the outstanding balance of the unpaid loan principal during every scheduled repayment period for the term of the loan;
- The lender and any service provider do not take vehicle security as a condition of the loan; and
- The loan is not structured as an open end credit.

For covered short-term loans meeting these standards, the lender must also review the consumer's borrowing history in its own records, the records of the lender's affiliates, and a consumer report from an "information system" that has been registered with the CFPB for at least 180 days.

Prior to making a covered short-term loan under this section, the lender must also determine that the following requirements are satisfied:

- The consumer has not had in the past 30 days an outstanding covered short-term loan or covered longer-term balloon-payment loan;
- The loan would not result in the consumer having a loan sequence of more than three covered short-term loans; and
- The loan would not result in the consumer having during any consecutive 12-month period: (i) More than six covered short-term loans outstanding; or (ii) Covered short-term loans outstanding for an aggregate period of more than 90 days.

Additional restrictions apply to covered short-term loans made under this conditional exemption, including additional disclosure requirements, and a prohibition against the lender or its affiliate making another covered short-term loan, or a non-covered loan to the same consumer while the first conditionally exempt loan is outstanding, or for a period of thirty days thereafter.

B. <u>Payments</u>

The Final Rule provides that it is an unfair and abusive practice for a lender to make attempts to withdraw payment from consumers' accounts in connection with a covered loan after the lender's second consecutive attempt to withdraw payments from the accounts from which the prior attempts were made have failed due to a lack of sufficient funds, unless the lender obtains the consumers' new and specific authorization to make further withdrawals from the accounts.[9] A "payment transfer" is defined broadly to include any lender-initiated debit or withdrawal of funds from a consumer's account for the purpose of collecting any amount due or purported to be due in connection with a covered loan.[10]

After a lender has initiated two consecutive failed payment transfers from a consumer's account, the Final Rule requires them to provide a "Consumer Rights Notice" that is substantially similar to a model disclosure form contained in Appendix A to the Final Rule, no later than three business days after it receives information that the second consecutive attempt has failed.[11]

There are limited exceptions to this restriction in cases of a single immediate payment transfer made at the consumers request in accordance with the Final Rule, or if the lender follows a detailed consumer approval process in accordance with the Final Rule that specifies the date, amount and payment channel of every additional payment transfer approved by the consumer.[12]

The limitations placed on payment transfers, coupled with the threat of regulatory enforcement action based on allegations of unfair or abusive practices, will likely force those lenders willing to make a covered loan away from the use of a Leveraged Payment Mechanism.

C. Information Furnishing, Recordkeeping, Anti-Evasion, and Severability

The Final Rule requires all lenders who make a covered-short term loan and covered longer-term balloon loan to furnish extensive "loan information" to an "information system" that is registered with the Bureau. While the payday lending industry is familiar with loan level reporting on an isolated state by state basis, the accumulation of loan level data in a national database is troubling. Among the information required to be reported to the information systems will be:

- Information to uniquely identify the loan;
- Information to uniquely identify the consumer;
- Whether the loan is a covered-short term loan or covered longer-term balloon payment loan;
- Whether the loan qualifies for a conditional exemption from the ability-to-repay requirements;
- Loan consummation date;
- If the loan is made under the conditional exemption from the ability to repay requirement, the principal amount borrowed;
- If the loan is closed-end credit, the fact that loan is closed end, the date that each payment on the loan is due; and the amount due on each payment date;
- If the loan is open-end credit, the fact that the loan is open-end, the credit limit on the loan, the date each payment is due, and the minimum amount due on each payment date;
- While the loan is outstanding, updates on any information contained in the system within a reasonable period of time of the event that causes the information previously furnished to become out of date; and

- Once the loan is no longer outstanding, the date it was no longer outstanding, and whether all amounts owed in connection with the loan were paid in full.[13]

CONCLUSION

The Final Rule was published in the Federal Register on November 17, 2017, and is effective as of January 16, 2018; however, compliance with the substantive provisions[14] of the Final Rule will not be required until the "Compliance Date" of August 19, 2019. Members of the Krieg DeVault Financial Institutions practice are monitoring further developments in the short term consumer lending industry, and able to assist with any questions you may have with respect to how the Final Rule may impact your institution.

[1] 12 U.S.C. § 5531
[2] For closed-end credit that does not provide for multiple advances to consumers, the consumer is required to repay substantially the entire amount of the loan within 45 days of consummation, or for all other loans, the
consumer is required to repay substantially the entire amount of the advance within 45 days of the advance under the loan
[3] For closed-end credit that does not provide for multiple advances to consumers, the consumer is not required to repay substantially the entire amount of the loan within 45 days of consummation, or for all other loans, the consumer is not required to repay substantially the entire amount of the loan within 45 days of an advance under the loan.
[4] 12 C.F.R. §§ 1041.4 and 1041.5
[5] **12 C.F.R. § 1041.5(a)** (1) *Basic living expenses* means expenditures, other than payments for major financial obligations, that a consumer makes for goods and services that are necessary to maintain the consumer's health, welfare, and ability to produce income, and the health and welfare of the members of the consumer's household who are financially dependent on the consumer.
[6] **12 C.F.R. § 1041.5(a)** (3) *Major financial obligations* means a consumer's housing expense, required payments under debt obligations (including, without limitation, outstanding covered loans), child support obligations, and alimony obligations.
[7] **12 C.F.R. § 1041.5(a)** (8) *Residual income* means the sum of net income that the lender projects the consumer will receive during the relevant monthly period, minus the sum of the amounts that the lender projects will be payable by the consumer for major financial obligations during the relevant monthly period and payments under the covered short-term loan or covered longer-term balloon payment loan during the relevant monthly period, all of which projected amounts are determined in accordance with paragraph (c).
[8] 12 C.F.R. § 1041.6
[9] 12 C.F.R. § 1041.7
[10] 12 C.F.R. § 1041.8(a)(1)
[11] 12 C.F.R. § 1041.9(c)
[12] 12 C.F.R. § 1041.8(c)
[13] 12 C.F.R. § 1041.10
[14] Sections 1041.2 through 1041.10, 1041.12, and 1041.13 have a compliance date of August 19, 2019.