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Legal Update
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The CFPB's Payday Proposal: Broader Than One May Think

Consumer lenders have a lot of reading to do these days. The Consumer Financial Protection Bureau (CFPB) recently proposed new ability-to-repay and other requirements applicable to a wide range of short-term and longer-term consumer loans. While the CFPB seeks to address unfair and abusive "debt traps" in payday, title and other high-cost loans, the 1334-page proposal is important not just to payday lenders but also to servicers of covered loans and consumer reporting agencies. And as the proposal represents the CFPB's first significant attempt at rulemaking under its authority to address unfair, deceptive, and abusive acts and practices (UDAAPs), rather than to implement provisions of a specific federal consumer financial law, the broader consumer financial services industry should take note of what the proposal suggests regarding the agency's thought process.

The proposed rule includes requirements for ability-to-repay determinations, payment processing, and reporting in connection with certain loans. The proposal generally covers loans of 45 days or less as well as certain longer-term loans that have an annual cost of credit of more than 36 percent and that include what the CFPB calls a "leverage payment mechanism" or a non-purchase-money security interest in a vehicle. This Legal Update describes the CFPB's use of its UDAAP authority, the types of consumer loans to which the proposal would and would not apply, and the proposed ability-to-repay requirement. It also describes other proposed restrictions and requirements for covered loans.

Comments on the CFPB's proposal are due September 14, 2016, and will supplement the public input the agency previously received on its initial outline from last year. After the CFPB finalizes its rule, it intends to provide a 15-month implementation timeline. If interested parties or groups challenge the rulemaking, that effective date could be pushed back further. Of course, the CFPB can in the meantime pursue lenders engaging in unfair, deceptive or abusive practices, including those in areas beyond the payday lending arena.

The lawyers in Mayer Brown's Consumer Financial Services Group have extensive experience preparing comment letters to regulatory proposals by the CFPB and other agencies. If you would like assistance preparing comments on the proposed rule, please contact one of the authors of this Legal Update.

A Medley of Rulemaking Authorities

The proposal marks the CFPB's first significant use of UDAAP rulemaking authority, providing lessons for payday and other lenders that are directly affected by the proposal as well as other companies subject to the CFPB's authority.

IDENTIFYING UDAAPs

The Dodd-Frank Act authorizes the CFPB to prescribe rules identifying acts or practices as unfair, deceptive, or abusive, as well as to enforce the Act's UDAAP prohibition. In its proposal, the CFPB has identified two practices as both unfair and abusive: to make a covered loan without reasonably determining that the consumer will have the ability to repay the loan, and to attempt to withdraw payment from a consumer's account in connection with a covered loan after the lender's second consecutive attempt has failed due to a lack of sufficient funds, unless the lender obtains the consumer's new authorization. The CFPB has not chosen to identify any practices as "deceptive" in the proposed rule, although it has the authority to do so.

Unfairness has a well-established statutory definition that focuses on whether there is likely to be substantial injury to consumers, whether the substantial injury is reasonably avoidable by the consumers, and whether the substantial injury is outweighed by countervailing benefits to competition. A secondary consideration is "established public policies."

The CFPB's analysis of abusiveness is more novel because this concept did not exist before the agency was created. For purposes of this rulemaking, the CFPB indicates that the practices it identifies "take unreasonable advantage of … a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service," and/or "take unreasonable advantage of … the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service."

The CFPB states that it recognizes that any consumer financial transaction may involve some "information asymmetry" between the consumer and the financial institution as well as uneven bargaining power. While the agency acknowledges that a market economy demands that financial institutions pursue their self-interests, the agency takes the position that they must not leverage their superior information or bargaining power to take "unreasonable advantage," and it is up to the CFPB to determine, based on all the facts and circumstances, when that line has been crossed.

PREVENTING UDAAPs

The CFPB does not stop, however, with merely requiring an ability-to-repay determination or prohibiting repeated attempts to withdraw funds from an insufficient account. Instead, the agency proposes a number of additional, specific requirements and alternatives for lenders in underwriting and offering these loans, as well as certain specific requirements regarding payment processing, all of which are discussed in greater detail below. Among other rulemaking authorities, the CFPB indicates that many of these additional detailed requirements are necessary "for the purpose of preventing" the unfair and abusive practices that it has identified. The CFPB asserts, based on case law regarding Federal Trade Commission rulemaking on unfair practices, that it can impose preventative requirements as long as there is a "reasonable relation" between those requirements and the unfair or abusive practices that it has identified.[1]

CONDITIONAL EXEMPTIONS

The Dodd-Frank Act also authorizes the CFPB to "conditionally exempt" classes of products or services from a rule after considering certain statutory factors. Using that authority, the CFPB has proposed several conditional exemptions, or safe harbors, for certain products, allowing those products to be offered without the full ability-to-repay analysis. A failure to comply with the conditions specified by the CFPB would not generally be an unfair or abusive practice in itself, but would subject the transaction to the regular requirements for a full ability-to-repay analysis.

ANTI-EVASION

Additionally, the Dodd-Frank Act authorizes the CFPB to prescribe rules "as may be necessary or appropriate to enable the Bureau to administer and carry out the purposes and objectives of the Federal consumer financial laws, and to prevent evasions thereof."[2] The CFPB has relied on this authority for several elements of the proposed rule, including an anti-evasion clause. In determining whether a person is evading the requirements of the rule, the CFPB would consider whether all relevant facts and circumstances reveal "the presence of a purpose that is not a legitimate business purpose."[3]

The CFPB also emphasizes that it will consider whether other practices akin to those addressed in its proposal are unfair, deceptive or abusive in connection with other types of loans. Thus, technical compliance with the rule, or structuring products so that they technically fall outside the scope of the rule, may not guarantee that a company escapes scrutiny or liability.

ENFORCEMENT OF THE PROPOSED RULE

If finalized, the proposed rule would be enforceable by the CFPB, the Federal Trade Commission, the federal banking agencies, state attorneys general and/or certain state banking regulators, depending on the circumstances. The CFPB may be able to obtain civil money penalties of as much as $1,087,450 per each day that each violation continued as well as disgorgement, consumer restitution, and/or other relief.[4]

LESSONS FOR FUTURE CFPB RULEMAKING

Going forward, the CFPB may issue a number of additional rules that rely on its UDAAP rulemaking authority. In particular, the CFPB is working on a debt collection rulemaking to impose requirements on various entities that collect debts but are not subject to the Fair Debt Collection Practices Act (FDCPA). The CFPB is also developing a regulation regarding overdraft practices that might exercise its UDAAP authority.

If this proposal is any guide, one lesson for future UDAAP rulemakings is that the CFPB may not stop at simply identifying and prohibiting UDAAPs themselves. It may also deploy additional authorities to impose a variety of procedures, disclosures, model forms and/or registration requirements.

The Proposal

The CFPB proposes to impose requirements on two types of consumer credit transactions.[5] The two types of loans contemplated by the rule would be differentiated by contractual duration, with "covered short-term loans" generally being loans with contractual durations of 45 days or less and "covered longer-term loans" being loans with contractual durations in excess of 45 days and subject to additional restrictions. More specifically:

i. **Covered short-term loans** would include any single-advance, closed-end loan requiring the consumer to repay substantially the entire amount of the loan within 45 days of consummation and any multiple-advance, closed-end or open-end loan requiring the consumer to repay substantially the entire amount of each advance under the loan within 45 days of the advance;[6] and

ii. **Covered longer-term loans** would include consumer loans of longer duration than covered short-term loans if (a) the total cost of credit for the loan exceeds 36 percent per year and (b) the lender obtains either a "leveraged payment mechanism" (discussed further below) or a non-purchase-money security interest in the consumer's vehicle no later than 72 hours after the consumer receives the entire amount of the loan.[7]

"COST OF CREDIT" FOR COVERED LONGER-TERM LOANS

When determining whether a loan is a "covered longer-term loan," the "cost of credit" would be similar to an annual percentage rate (APR)

calculation under the federal Truth in Lending Act and Regulation Z (TILA). But the calculation would take into account certain fees not otherwise considered finance charges for TILA purposes, including: (i) charges incurred in connection with credit insurance, debt cancellation or debt suspension plans no later than 72 hours after the consumer receives the entire amount of the loan, even if excludable from the finance charge under TILA; (ii) charges incurred in connection with credit-related ancillary products such as credit report monitoring or identity theft prevention products that are sold in connection with the loan (even by third parties not affiliated with the creditor) no later than 72 hours after the consumer receives the entire amount of the loan; (iii) application fees; and (iv) plan participation fees.[8]

For open-end credit, the calculation must use the TILA rules to determine an effective APR for a billing cycle, assuming full credit line utilization. The method for calculating the cost of credit for open-end accounts may serve as a trap for certain open-end lenders who may not believe they are offering higher-cost products because it treats fees as applying within a single billing cycle even if they cover the cost of line access or a credit-related product or service for a period extending beyond one billing cycle. CFPB commentary to the proposal presents an example of an open-end account: (i) with a $500 credit limit; (ii) repayable over monthly billing cycles through recurring Electronic Funds Transfers (EFTs), though not requiring full repayment of advances each month; (iii) bearing periodic interest at an annual rate of 8.25 percent (or 0.6875 percent per month); and (iv) for which the creditor charges a $25 fee when the account is opened and annually thereafter. The comment clarifies that this account would have a cost of credit of 68.26 percent for the purposes of the proposal and would therefore be a "covered longer-term loan." The calculation involves treating the sum of $3.44 in periodic interest (the periodic rate applied to a fully utilized line for one monthly billing cycle) and the full $25 fee as the applicable cost for a monthly billing cycle, multiplying by 12 billing cycles and dividing the resulting total of $341.28 by the $500 fully-utilized line.[9] Were the $25 participation fee spread out over the period to which it applies rather than being treated as charged each monthly billing cycle, the annualized cost of credit would arguably be only 13.25 percent. A consumer having $500 outstanding on the account for a period of one year (corresponding to the period over which the $25 participation fee applies) would pay total charges of $41.25 in periodic interest (assuming no compounding) and a single $25 participation fee for a total cost of $66.25. Interest application rules such as compounding would change the calculation slightly but would not result in a cost anywhere near the $341.28 implied by the CFPB's calculation.

"LEVERAGED PAYMENT MECHANISM" FOR COVERED LONGER-TERM LOANS

In developing its proposal, the CFPB assumed that the combination of higher-priced loans with the "preferred payment position derived from a leveraged payment mechanism or vehicle security" would reduce a lender's incentive to underwrite a consumer's ability to repay.[10] The ability to recover funds from consumers' deposit accounts, sources of income, or vehicles could result in circumstances in which higher-priced loans are underwritten based on collateral sufficiency rather than based on a consumer's ability to repay. Accordingly, the CFPB proposes to cover longer-term loans when they provided the creditor a "leveraged payment mechanism" or non-purchase-money security interest in the consumer's vehicle.

"Leveraged payment mechanisms" would include a variety of means of accessing consumer deposit accounts or sources of income, including: (i) the right to initiate transfers from a consumer's account other than by initiating a one-time EFT immediately after the consumer

authorizes the transfer; (ii) the right to obtain payment directly from the consumer's employer or other source of income; or (iii) requiring the consumer to repay through a payroll deduction or deduction from another source of income. Commentary to the proposal clarifies that a lender will be deemed to have obtained a leveraged payment mechanism or non-purchase-money security interest in the consumer's vehicle no later than 72 hours after the consumer receives the entire amount of the loan if: (i) the lender actually obtains the mechanism or interest within that timeframe; or (ii) the consumer becomes contractually obligated within that time to provide the mechanism or interest after the expiration of the 72-hour window.

PRODUCTS EXEMPTED FROM THE PROPOSAL'S REQUIREMENTS

While the CFPB proposal applies to a wide range of consumer credit transactions, there are six product-level exceptions:

i. Purchase money loans in which a security interest is taken in purchased goods (including purchase-money vehicle loans) and that are for the sole and express purpose of financing a consumer's initial purchase of a good;
ii. Residential mortgage loans;
iii. Credit card accounts subject to the Credit CARD Act of 2009 (i.e., any "credit card account under an open-end (not home-secured) consumer credit plan" as defined by Regulation Z);
iv. Student loans;
v. Non-recourse pawn transactions in which the consumer does not retain possession and use of the pledged collateral during the term of the loan; and
vi. Overdraft services and lines of credit (including such products when offered in connection with prepaid cards).[11]

As with many provisions of the proposal, the CFPB expressly solicits comments regarding whether it has drawn appropriate boundaries for exempted products. In addition, the CFPB warns that it "may consider on a case-by-case basis, through its supervisory or enforcement activities, whether practices akin to those addressed [in the proposal] are unfair, deceptive, or abusive in connection with loans not covered by this proposal."[12]

Ability-to-Repay Requirements

The proposal would create a multi-tiered underwriting requirement for covered short-term and longer-term loans. In general, the lender would be required to make a reasonable determination that the consumer will have the ability to repay such loans. The lender generally would have to verify certain consumer information and conclude that the consumer's income will be sufficient to make the payments under the loan while also covering the consumer's major financial obligations and basic living expenses. As explained below, presumptions of inability to repay would apply in certain circumstances and would be different for covered short-term and longer-term loans. Moreover, lenders would be able to avoid application of the general requirement by originating a safe-harbor product.

For traditional payday lending, the exceptions may swallow the rule. Comprehensive underwriting for small-dollar loans may be difficult, so lenders may stick with the proposed safe-harbor products described below. For these safe-harbor products, there will be strict limits on loan size and the number and duration of loans that may be taken out by a single borrower in a 12-month period as well as limits on repeat borrowing.

For longer-term loans, lenders in the prime, near-prime and top-end of the sub-prime categories may choose to avoid the rule altogether by limiting the cost of credit to 36 percent.

GENERAL UNDERWRITING REQUIREMENTS

Under the proposal, covered loans would be subject to a general ability-to-repay requirement. For closed-end covered loans, the ability-to-repay determination would have to be made prior to consummation. For open-end covered loans, the ability-to-repay determination would have to be made prior to the initial advance or increase in available credit and then again for an additional advance taken more than 180 days after the date of the prior ability-to-repay determination.

To verify the consumer's income for the ability-to-repay determination, the lender must obtain reliable records such as records from the income source itself or transaction records from a consumer's depository or prepaid account. The lender must obtain a credit report on the consumer in order to verify debt and child support obligations. The lender also must analyze its own records and those of its affiliates. In addition, the lender must obtain a consumer report from a registered "information system" (if such a system is available, as discussed below). The lender also may need to obtain a lease or other records in order to verify housing expenses or find a reliable method of estimating a consumer's housing expense based on the housing expenses of consumers with households in the same locality.

In addition, the lender would have to obtain a written statement from the consumer that explains the amount and timing of the consumer's income and major financial obligations. While the consumer's statement is not wholly reliable on its own, the CFPB explains that it is an important component for projecting future net income and payments because it is often helpful in resolving ambiguities that arise in the verification evidence.

For a covered short-term loan, the ability-to-repay determination would require a reasonable conclusion that:

i. The consumer's residual income will be sufficient to make all payments under the loan and to meet basic living expenses for the shorter of the term of the loan or 45 days following consummation; and

ii. The consumer will be able to make payments required for major financial obligations as they fall due, to make any remaining payments under the loan and to meet basic living expenses for 30 days after the due date of the highest payment required under the loan.

The CFPB notes that most covered short-term loans are due in a single payment, so this standard would require the lender to determine that even after making that payment, the consumer will still be able to meet his/her living expenses. For a covered longer-term loan, the lender must conclude that the consumer can repay the loan and his/her basic living expenses over the term of the loan.[13]

The lender would have to determine that the consumer can make his or her payments "as they fall due." Proposed commentary would provide an example in which: (i) a covered loan requires a payment on April 29 that will "consume all but $1,000 of the consumer's last paycheck preceding or coinciding with the date of the loan payment;" (ii) the consumer will not receive another paycheck until May 13; and (iii) the consumer will have a $950 rent payment and a $200 student loan payment due on May 1 and May 5, respectively.[14] Since the consumer will not have sufficient income after the covered loan payment to make the two major debt obligation payments "as they fall due," the lender cannot make a reasonable determination that the borrower has the ability to repay the loan.

PROVISIONS SPECIFIC TO COVERED SHORT-TERM LOANS

Prohibitions and Rebuttable Presumptions Related to Inability to Repay

Since the CFPB is seeking to eliminate what it perceives to be the debt traps that may be lurking unfairly in payday, title, or certain other loans, the proposal would establish certain absolute prohibitions concerning the consumer's inability to repay as well as certain presumptions that can be rebutted with evidence. To effectuate the prohibitions and rebuttable presumptions, the proposal requires that lenders review the consumer's borrowing history, relying on the records of the lender and its affiliates as well as a consumer report obtained from a "registered information system."

Lenders would be prohibited from making a covered short-term loan: (i) if the loan would be the fourth in a sequence of covered short-term loans made under the general underwriting requirement without the consumer taking a 30-day cooling-off period between two such loans; or (ii) following a short-term safe-harbor loan, unless the borrower takes a 30-day cooling-off period.

The rule also proposes limitations on covered short-term loans (i.e., rebuttable presumptions of inability to repay) that apply *unless* the lender can show that the consumer will have sufficient improvement in financial capacity to be able to repay the new loan. For instance, the rule would generally require a 30-day cooling-off period after repaying a covered short-term loan and before obtaining a new covered short-term loan. However, that cooling-off period does *not* apply in the following circumstances:

i. The consumer has repaid the prior loan and the new loan would be limited in amount (including all charges) to half the prior loan, and the term of the new loan is not longer than the period over which the consumer made a payment(s) on the prior loan;

ii. Rolling a prior loan into a new loan generally represents a declining balance (i.e., considering the rolled-over remaining balance and the new loan, the consumer would not owe more than he or she paid on the prior loan), and the term of the new loan is not longer than the period over which the consumer made a payment(s) on the existing loan; or

iii. The lender reasonably determines, based on reliable evidence, that the consumer's financial capacity is sufficiently improved since obtaining the prior loan, despite the unaffordability of that loan.

The rule proposes important specifications for implementing these exceptions.

The rule also would generally require a 30-day cooling-off period after repaying a covered longer-term balloon payment loan. It would also generally prohibit making a covered short-term loan to a consumer who has any loan outstanding with the lender or its affiliate if: (i) there are specified indications of financial distress; (ii) the first payment will be due after the consumer would have to make a payment on the outstanding loan; or (iii) the proceeds of the new loan are not much more than the impending payments due on the outstanding loan. However, both this cooling-off period after a longer-term balloon loan and the restrictions on loans to a current customer could be avoided if the lender can demonstrate that the consumer's financial capacity has sufficiently improved.

While it is clear the CFPB has set its targets on certain lending circumstances that could create a cycle of improper debt, its web of specifications, restrictions, prohibitions, rebuttable presumptions and conditional exceptions will be difficult for lenders to absorb and implement. The CFPB's proposal would create a strong incentive to avoid that web by making safe-harbor loans as described below.

Short-Term Safe-Harbor Loans

A lender making a covered short-term loan may avoid the application of the general ability-to-repay requirement and the prohibitions and presumptions described above by originating a loan that fits within the CFPB's proposed safe harbor. The CFPB designed its short-term safe-harbor loan to allow borrowers to step down to lower debt levels and avoid a perpetual cycle of debt. In order to take advantage of this safe harbor, a lender's short-term loan would have to meet the rule's restrictions on loan amount and declining balances (as described below), the loan must be closed-end and fully amortizing, and the lender must not take an interest in the consumer's vehicle. The lender may only make up to three such loans in a sequence, after which the lender would need to provide a 30-day cooling-off period.

As indicated above, although the lender may make up to three safe-harbor loans in a row, the first loan cannot exceed $500, and the second and third loans in the sequence must have principal balances not more than two-thirds and one-third of the amount of the initial loan, respectively. In any consecutive 12-month period, the consumer may not have more than six covered short-term loans outstanding or have covered short-term loans outstanding for an aggregate period of more than 90 days. The lender would have to verify the consumer's borrowing history to ensure that: (i) the consumer does not have an outstanding covered loan that the lender would be rolling over; (ii) the consumer does not have, and has not had in the past 30 days, an outstanding covered short-term loan (other than a safe-harbor loan as described above) or covered longer-term balloon payment loan; and (iii) the loan would not be the fourth in a sequence of short-term safe-harbor loans made without a 30-day cooling-off period.

The proposal requires, and includes model forms for, disclosures for each of the loans in the sequence. The rule would allow, but would not require, making the disclosures in a language other than English, although the lender would have to make English language disclosures available upon request.

PROVISIONS SPECIFIC TO COVERED LONGER-TERM LOANS

Prohibitions and Rebuttable Presumptions Related to Inability to Repay

Covered longer-term loans are subject to somewhat different prohibitions and rebuttable presumptions.

First, a lender would be prohibited from making a covered longer-term loan while the consumer has a safe-harbor short-term loan from that lender or its affiliate that is outstanding and for 30 days thereafter.

Second, similar to the proposal for covered short-term loans, the rule would generally require a 30-day cooling-off period before making a covered longer-term loan to a consumer after he or she pays off a covered short-term loan or a longer-term balloon payment loan. However, the rule would establish that restriction as a rebuttable presumption of inability to repay. The cooling-off period would not be required if:

i. Every payment on the new covered longer-term loan would be substantially smaller than the largest required payment on the prior loan; or
ii. The lender reasonably determines, based on reliable evidence, that the consumer's financial capacity is sufficiently improved since obtaining the prior loan despite the unaffordability of that loan.

The rule would also generally prohibit making a covered longer-term loan to a consumer who has any loan outstanding with the lender or its affiliate if: (i) there are specified indications of financial distress; (ii) the first payment will be due after the consumer would have to make a payment on the outstanding loan: or (iii) the proceeds of the new loan are not much more

than the impending payments due on the outstanding loan. However, that prohibition would not apply if: (i) the size of every payment on the new loan would be substantially smaller than the size of every payment on the outstanding loan; (ii) the new loan would result in a substantial reduction in the total cost of credit; or (iii) the lender can demonstrate that the consumer's financial capacity has sufficiently improved since obtaining the prior unaffordable loan.

Rebuttable presumptions of an inability to repay would apply to:

i. Any covered longer-term loan taken out while a covered short-term loan or a covered longer-term balloon loan made under the general underwriting requirements is outstanding, or within 30 days thereafter, unless every payment of the new loan would be substantially smaller than the largest required payment on the old loan; and
ii. Any covered longer-term loan taken out while the consumer has a covered or non-covered loan outstanding that was made or serviced with the lender or its affiliate and for which the consumer shows certain signs of financial distress or the relationship between the new and old loans suggests the borrower had been captured by a cycle of debt. This rebuttable presumption would not apply if each payment under the new loan would be substantially smaller than each payment under the old loan, or the new loan would result in a substantial reduction in the total cost of credit relative to the old loan.

Longer-Term Safe-Harbor Loans

The proposal also establishes two safe-harbor products for covered longer-term loans.

The first safe-harbor product is modeled on the National Credit Union Administration (NCUA) Payday Alternative Loan.[15] To take advantage of the safe harbor and generally avoid the restrictions and requirements described above: (i) the loan must be a closed-end loan, between $200 and $1,000 in principal amount and not more than six months in duration; (ii) the loan must be repayable in two or more fully amortizing, substantially equal payments due no less frequently than monthly; and (iii) the total cost of credit must not be more than the permissible cost for an NCUA Payday Alternative Loan (currently 28 percent periodic interest plus an application fee up to $20).[16] The loan must not contain a prepayment penalty or provisions permitting any lender to sweep the consumer's deposit account to a negative balance, exercise a set-off right, place a hold on the account or close the account in response to an actual or expected delinquency or default on the loan.

A lender making this first type of longer-term safe-harbor loan would be required to review its records and the records of its affiliates to ensure that the consumer is not indebted to the lender or its affiliates on more than three loans originated under this safe harbor in any given 180-day period. In addition, the lender must maintain and comply with policies and procedures for documenting proof of recurring income.

The second longer-term safe-harbor product is a closed-end loan of up to 24 months. Similar to the first safe-harbor product, the loan would have to be repayable in two or more fully amortizing payments with substantially equal periodic payments due no less frequently than monthly. The total cost of credit for the loan would have to be no greater than 36 percent plus the value of a limited origination fee. The loan must not contain a prepayment penalty or permit a lender to sweep the consumer's deposit account to a negative balance, exercise a set-off right, place a hold on the account or close the account in response to an actual or expected delinquency or default on the loan. A lender making this second type of longer-term safe-harbor loan would be required to review its records and the records of its affiliates to ensure

that the consumer is not indebted to the lender or its affiliates on more than two loans originated under the second safe harbor in any given 180-day period.

In addition, this second type of safe-harbor longer-term loan would essentially require the lender to maintain a portfolio default rate on those loans that is no higher than 5 percent per year. If the lender's default rate exceeds that amount, the lender would be required to refund all the origination fees charged to borrowers for those loans over that year. The default rate for this purpose relates to safe-harbor loans that have either been at least 120 days' delinquent or were charged off during that year, and the percentage is measured based on outstanding balances (not number of loans). The need to refund those origination fees based on an excessive default rate would not, however, affect the safe-harbor status of the loan or the lender's ability to make safe-harbor loans going forward.

In its 2015 outline for this proposal, the CFPB described an NCUA-type product as one of two safe harbors that would comply with the ability-to-repay requirement.[17] However, the outline's safe-harbor loan could have been no longer than six months, but it had no portfolio default aspect and would have generally permitted the payment on the loan to be as much as 5 percent of the consumer's income. Several banks indicated support for "5% of income" payday loan products. While the CFPB apparently decided not to propose such a safe-harbor product, it is unclear whether banks or other lenders would be willing to bear the risk of the proposed portfolio default refund provision. Lenders may find more flexibility in the fact that the proposed product may be longer in duration (24 months, as opposed to six months as described in the outline), particularly if they can avoid the complexity of verifying the consumer's income.

Additional Obligations for Lenders and Servicers of Covered Loans

PAYMENT PROCESSING REQUIREMENTS

The proposal addresses CFPB concerns that the servicer of a covered loan might routinely attempt to draw payment from a consumer's account even when it knows, or has reason to know, that the consumer does not have sufficient funds in the account to make the required payment. Such a practice may result in the consumer being charged multiple non-sufficient funds (NSF) fees from the servicer and/or the institution holding the consumer's account.

Accordingly, the proposal would generally limit a servicer to two consecutive failed attempts at withdrawing payments from a consumer's account before the servicer would be required to obtain a new payment authorization from the consumer. A new payment authorization obtained after two failed attempts must either be a signed, written authorization or an oral authorization provided on a recorded telephone call that is later memorialized by the servicer in writing no later than the date on which the first payment transfer attempt under the new authorization is initiated. The proposal requires several disclosures to be made in connection with payment attempts and provides model forms for each such disclosure.

INFORMATION FURNISHING REQUIREMENTS

Various provisions of the proposal relating to presumptions of inability-to-repay and safe-harbor loan products require the lender to assess the consumer's covered loan borrowing history. In order to facilitate these requirements, the proposal requires certain information to be furnished to "information systems" and/or traditional national consumer reporting agencies for all covered loans. All of the proposal's

information furnishing requirements formally apply to the lender, though some of the requirements relating to information furnishing for outstanding and satisfied loans will likely be implemented by loan servicers on lenders' behalf.

For covered loans other than longer-term safe-harbor loans, the lender must furnish certain information to each "information system" that, as of the date the loan is consummated, has been registered or provisionally registered with the CFPB for 120 days or more or that has moved from provisional registration to full registration. Information must be submitted at or before consummation, while the loan is outstanding and when the loan ceases to be an outstanding loan (i.e., when the loan is fully repaid or when the loan reaches 180 days' delinquency). The information to be furnished includes information regarding the terms of the loan, how it was originated and its payment status. Information must be furnished in a format acceptable to each information system.

For longer-term safe-harbor loans, the lender may choose the manner in which it will furnish information. It may choose to furnish information to registered "information systems" as would be required for all other covered loans. Alternatively, it may furnish information to a national consumer reporting agency at the earlier of: (i) the time of the lender's next regularly scheduled furnishing to such consumer reporting agency; or (ii) within 30 days of consummation of the loan.

COMPLIANCE SYSTEM AND RECORDKEEPING REQUIREMENTS

The proposal also establishes various ancillary requirements intended to develop a broader compliance structure around the core ability-to-repay requirements and to permit the CFPB to enforce the requirements. First, it is not sufficient to simply comply with the substantive requirements of the proposed rule. Each lender making covered loans must develop and follow a compliance program, including written policies and procedures, that is reasonably designed to ensure compliance with the requirements of the proposal. Second, lenders must retain certain records for 36 months after the date on which any covered loan ceases to be an outstanding loan. Records required to be retained include: (i) each covered loan agreement; (ii) consumer reports obtained from registered information systems; (iii) verification evidence in connection with covered loans, including statements obtained from the consumer; (iv) payment transfer authorization documents; (v) information regarding underwriting calculations for loans originated under the general underwriting requirements; (vi) information regarding exceptions to the ability-to-repay requirement or overcoming a presumption of inability to repay; (vii) information regarding loan types and terms; and (viii) information regarding payment history and loan performance. Some of these records must be maintained as electronic records in a tabular format and must contain specific required elements.

Registered Information Systems

To facilitate compliance with the rule's underwriting requirements, the CFPB proposes to establish a process for registering "information systems" to which lenders would be required to furnish information about most covered loans and from which lenders would be required to obtain consumer reports when originating covered loans. Under the rule, entities seeking to become registered information systems before the effective date of the proposal's information system provisions could apply for preliminary approval; those seeking to register after the effective date would first need to be provisionally registered for a period of time.

In order to become registered, an entity must demonstrate that it meets the following criteria: (i) has the ability to receive furnished

information; (ii) has the ability to generate consumer reports containing information substantially simultaneously as it is received; (iii) performs or will perform in a manner that facilitates compliance with the proposal; (iv) has an acceptable compliance program with respect to federal consumer financial laws; and (v) has an acceptable information security program. The entity must also consent to being supervised by the CFPB. In all cases, the entity's compliance management and information security programs must be assessed to the satisfaction of a qualified, objective and independent third party.

Conclusion

The CFPB's first UDAAP rulemaking proposal, if finalized, is likely to significantly reduce traditional payday lending and cause installment and vehicle title lenders to think carefully about whether higher rates and leveraged payment mechanisms are worth the regulatory burden. On the other hand, the rulemaking may provide certain credit reporting agencies with a new market opportunity. Stakeholders should review the rule and its official commentary to ensure they understand the obligations that would apply to them. If limitations under the proposal would adversely affect their businesses, it may prove worthwhile to submit comments to the CFPB suggesting that substantive or technical changes be made in the final rule.

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Endnotes

[1] Proposal at 130 (quoting *Am. Fin. Servs. Ass'n v. FTC*, 767 F.2d 957, 988 (D.C. Cir. 1985) (quoting *Jacob Siegel Co. v. FTC*, 327 U.S. 608, 612-13 (1946))).

[2] 12 U.S.C. § 5512(b)(1) (emphasis added).

[3] Proposal at 1330 (to be codified at 12 C.F.R. pt. 1041, supp. I, comment 19-1).

[4] *See* 12 U.S.C. § 5565; Civil Penalty Inflation Adjustments, 81 Fed. Reg. 38,569, 38,571 (June 14, 2016) (to be codified at 12 C.F.R. § 1083.1(a)).

[5] Proposal at 1128 (defining "consumer," to be codified at 12 C.F.R. § 1041.2(4)), 1132 (defining "covered loan," to be codified at 12 C.F.R. § 1041.3(b)).

[6] Proposal at 1129, 1132–33 (defining "covered short-term loan," to be codified at 12 C.F.R. §§ 1041.2(6), 1041.3(b)(1)).

[7] Proposal at 1129, 1133 (defining "covered longer-term loan," to be codified at 12 C.F.R. §§ 1041.2(8), 1041.3(b)(2)).

[8] Proposal at 1131–32 (indicating the "charges included in the total cost of credit," to be codified at 12 C.F.R. § 1041.2(18)(i)-(ii)). In its 2015 outline for this proposal, the CFPB suggested it was considering using an all-in cost of credit metric already in use under federal law in order to ease compliance burdens on lenders. The specific metric under consideration was the Military APR (MAPR) under the Military Lending Act. 2015 SBREFA Outline at 19. Under recent amendments effective October 2015 (with compliance required by October 2016), the MAPR calculation would be nearly identical to the CFPB's proposed cost of credit, differing only in that an application fee charged by credit unions or insured depository institutions in connection with certain short-term, small amount loans is not included in the MAPR calculation. *See* 32 C.F.R. § 232.4(c).

[9] Proposal at 1207 (to be codified at 12 C.F.R. pt. 1041, supp. I, comment 2(18)(iii)(B)-2).

[10] Proposal at 176.

[11] Proposal at 1134–35, 1208–09 (to be codified at 12 C.F.R. § 1041.3(e) and associated commentary).

[12] Proposal at 168.

[13] Proposal at 1151 (to be codified at 12 C.F.R. § 1041.9(b)(2)). A covered longer-term loan is a "covered longer-term balloon payment loan" if it is a single-payment loan or a

loan in which any one payment is more than twice as large as any other payment under the loan. Proposal at 1129 (to be codified at 12 C.F.R. § 1041.2(7)).

[14] Proposal at 1218–19 (to be codified at 12 C.F.R. pt. 1041, supp. I, comment 5(b)(2)(ii)-1(i)).

[15] *Compare* Proposal at 1156–58 (to be codified at 12 C.F.R. § 1041.11) *with* 12 C.F.R. § 701.21(c)(7)(iii).

[16] Proposal at 1156–57 (to be codified at 12 C.F.R. § 1041.11(b)).

[17] 2015 SBREFA Outline at 26–27.

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