

MEMORANDUM

To: Clients of Hudson Cook, LLP

From: Hudson Cook, LLP

Date: June 8, 2016

Subject: Payday, Vehicle Title, and Certain High-Cost Installment Loans Proposed Rule

On June 2, 2016, the Consumer Financial Protection Bureau (“CFPB”) issued its proposed rule (“Rule”) to curtail how lenders originate payday, vehicle title, and certain high-cost installment loans, both closed-end or open-end, regardless of the form or structure of the credit product, unless exempted (“Covered Loans”).

Covered Loans

- So-called short-term loans with a term of 45 days or less.
- So-called “longer-term” loans that exceed 45 days where the total cost of credit exceeds 36% per year and the lender obtains either a security interest in the consumer’s vehicle (“title loan”) or a “leveraged payment mechanism.”

The Rule’s 36% per year trigger refers to an “all-in” APR substantially similar to the Military APR under the Military Lending Act.

The Rule broadly defines “leveraged payment mechanism” to include “a transfer of money, through any means.” The most common “leveraged payment mechanism” is a consumer’s signed recurring funds transfer, but also includes mechanisms that give the lender: (1) the right to initiate a recurring transfer of money from a consumer’s account; (2) the right to payment directly from the consumer’s employer; or (3) the right to payment through a payroll deduction. Leveraged payment mechanism includes, among other things, paper checks, remotely created checks, remotely created payment orders, and electronic fund transfer authorizations.

The Rule covers so-called longer-term loans if the lender obtains a security interest in the consumer’s vehicle or leveraged payment mechanism at the same time as, or within 72 hours after, the consumer receives all funds under the loan. However, if the *loan agreement* authorizes the lender to elect to obtain a leveraged payment mechanism or provides the consumer incentive to opt-in, the Rule covers the loan, regardless of when the lender obtains the leveraged payment mechanism.

Excluded Loans

- Purchase money loans (expressly limited to the cost of the goods and does not include refinances of a purchase money loan);
- Real estate secured credit, including home mortgages and credit secured by personal property used as a dwelling;
- Credit cards;
- Student loans, both federal and private;
- Non-recourse pawn loans; and
- Overdraft services and lines of credit.

Substantive Requirements – Ability to Repay

For Covered Loans, lenders must ensure the consumer has the “ability to repay” before originating a Covered Loan to a consumer. **The failure to determine a consumer’s ability to repay any Covered Loan constitutes an abusive and unfair practice.**

Lenders must verify the consumer’s ability to repay the loan.¹ The verification comes in the form of a written statement from the consumer as well as “verification evidence.” The lender must verify the information provided in the statement. The lender makes a reasonable determination of the consumer’s ability to repay by accounting for the consumer’s basic living expenses, income and major financial obligations. Lenders may verify housing expenses by records of expense payments, a lease or other “reliable method of estimating” housing expenses in the borrower’s locality. The Rule has built-in presumptions, such as a presumption that a consumer cannot afford a new loan when the consumer is seeking a covered short-term loan within 30 days of repayment of a prior covered short-term loan or a covered balloon payment longer-term loan. To overcome these presumptions, a lender must document sufficient improvement in the consumer’s financial capacity. A lender cannot originate a covered short-term loan to a consumer who already obtained three covered short-term loans within 30 days of each other.

Specifically, in order to establish a consumer’s ability to repay, a lender must:

- Verify the consumer’s net income;
- Verify the consumer’s debt obligations using a national consumer report and a consumer report from a “registered information system” (described herein);
- Verify the consumer’s housing costs or use a reliable method of estimating a consumer’s housing expense based on the housing expenses of similarly situated consumers;

¹ For open-end credit, a lender must make an ability to repay analysis on any cash advance in which a previous ability to repay has not been conducted within 180 days.

- Forecast a reasonable amount of basic living expenses for the consumer, including expenditures (other than debt obligations and housing costs) necessary for a consumer to maintain her or his health, welfare, and ability to produce income;
- Project the consumer's net income, debt obligations, and housing costs for the term of the loan; and
- Determine the consumer's ability to repay the loan based on the lender's projections of the consumer's income, debt obligations, and housing costs and forecast of basic living expenses for the consumer.

In addition to these requirements, lenders of longer-term loans must "reasonably account" for the possibility of volatility in the consumer's income, obligations, or basic living expenses during the term of the loan. It is unclear whether the required installment payment may equal the "residual income" during the same time period or whether the payment must be less than the residual income.

Ability to Repay Alternatives – Closed-end Loans

Short-Term Loans - "Principal Payoff Option." In lieu of determining the "ability to repay," lenders may originate up to three sequential loans in which the first loan has a principal amount up to \$500, the second loan has a principal amount at least one-third smaller than the principal amount of the first loan, and the third loan has a principal amount at least two-thirds smaller than the principal amount of the first loan. A lender cannot use this option if it results in the consumer having more than six covered short-term loans during a consecutive 12-month period or being in debt for more than 90 days on covered short-term loans during a consecutive 12-month period.

A lender using this option cannot take vehicle security, and cannot structure the transaction as open-end credit. Certain notices are also required for the first loan, and for consumers who qualify for sequential loans under the proposal's limitations, a notice is also required for the third loan in a sequence.

Longer-Term Loans. The Rule permits two alternatives, both of which limit the number of loans a lender can originate to a consumer in a 180-day period.

National Credit Union Administration Alternative. The loan has a principal amount of not less than \$200 and not more than \$1,000, with repayment in two or more fully amortizing, substantially equal payments due no less frequently than monthly and in substantially equal intervals and a term of at least 46 days and not more than six months. The annualized interest rate cannot exceed 28% inclusive of all fees; the lender may impose a separate application fee that cannot exceed \$20 and must reflect the actual cost of processing the application.

36% All-In APR Alternative. The total cost of credit cannot exceed an annual rate of 36% (excluding a single origination fee of up to \$50 or in "reasonable proportion" to the lender's underwriting costs). The minimum loan is 46 days and cannot exceed 24 months. The loan is repayable in two or more fully amortizing and substantially equal payments, with payments due no less frequently than monthly and in substantially equal intervals. Finally, the lender's projected default rate on all loans originated under this option cannot exceed 5%. If the default rate in any year exceeds 5%, the lender

must refund all origination fees paid by all borrowers whose loans were included in the default rate calculation.

Payments

The Rule generally deems more than two attempts to withdraw payment from a consumer's account in connection with a Covered Loan an abusive and unfair practice, with few exceptions. Lenders must provide notice to consumers of Covered Loans after the second withdrawal attempt and follow certain procedures in obtaining new authorizations. In addition, a lender must provide a written notice at least three business days before each attempt to withdraw payment for a Covered Loan from a consumer's checking, savings, or prepaid account. The notice must include information such as the date of the payment request, payment channel, payment amount (identified by principal, interest and fees), and additional information for "unusual attempts," such as when the payment amount varies from the regular payment amount or the lender initiates payment on a date other than the date of a regularly scheduled payment. If two consecutive attempts to collect money from a consumer's account made through any channel are returned for insufficient funds, the lender cannot make any further attempts to collect from the account unless the consumer provided a new authorization.

Registered Information Systems

The Rule would create a specialty credit reporting mechanism for Covered Loans through the use of "registered information systems." "Registered information systems" are consumer reporting agencies that meet certain criteria and register with the CFPB. Lenders must furnish information to these "registered information systems" about certain Covered Loans and borrowers at origination, over the life of the loan, and when the loan is no longer outstanding. The lender must furnish the information to all "registered information systems." Additionally, lenders must obtain consumer reports from "registered information systems" prior to extending certain Covered Loans to borrowers for use in making ability to repay determinations. In order to qualify as "registered information systems," credit reporting agencies must meet certain eligibility criteria and provide a reasonably comprehensive record of a consumer's recent and current borrowing history.

Compliance Program and Recordkeeping

Lenders must establish and follow a compliance program reasonably designed to ensure that the lender complies with the requirements in the Rule. Further, the lender must comply with certain recordkeeping requirements for Covered Loans, including retaining the loan agreement, related documentation, and additional information in electronic records for 36 months after the last activity on the account.

Timeline

Interested parties may submit comments on the Rule to the CFPB by September 14, 2016. The effective date of the Rule once promulgated will be 15 months after publication. We anticipate that the Rule will take effect in late 2018. The CFPB also issued a Request for Information on "other potentially high-risk loan products and practices that are not specifically covered" by the Rule, with comments due October

14, 2016. This Request suggests additional rulemaking to address installment loans where the lender does not take a vehicle title as collateral or gain account access.

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