

A Deeper Dive: The CFPB Short-Term Small-Dollar Lending Rule

Introduction

By now you've likely heard that the Consumer Financial Protection Bureau (CFPB) has released a final small-dollar lending rule. The hallmark of the rule is the requirement that lenders make a reasonable determination that a borrower has the ability to repay a loan while also meeting basic living expenses, prior to issuing a consumer loan with a repayment term of under 45 days. The rule however, is much more complex than that simple proposition. We are issuing this white paper so that industry participants can better understand the challenges and opportunities provided for by the rule. Following the format of the rule, we'll address (1) which lenders and loans are covered; (2) exempt transactions and lenders; (3) underwriting and disclosure requirements; (4) payment withdrawal limitations; and (5) information furnishing and recordkeeping requirements.

Covered Loans

In a change from the CFPB's 2016 proposed rule, the final rule largely bifurcates the regulation of loans with repayment periods of less than 45 days and loans with repayment terms of greater than 45 days. The underwriting requirements of the rule only apply to (1) consumer loans where the consumer is required to pay substantially the entire amount of the loan within 45 days of *consummation*¹, for closed-end credit, or *advance*, for open-end credit;² and (2) closed-end loans that must be substantially repaid in more than 45 days, if those loans include a balloon payment feature.³ If a loan has a full repayment term of greater than 45 days as well as an annual percentage rate (APR) of greater than 36 percent and the lender utilizes a leveraged payment mechanism⁴ to collect amounts due, then that loan will not be subject to the underwriting requirements, but originators of such loans will still need to comply with the payment withdrawal limitations.

Exemptions

The CFPB exempted distinct categories of lenders and loan products in its final rule. Certain exemptions, such as those for credit cards, real-estate secured credit, and student loans, likely exist because other existing or future rules are better vehicles for regulating those products. Other exemptions, however, reflect the CFPB's willingness to allow some entities to continue making short-term small-dollar loans that consumers want, or need, to access. For example, the CFPB exempted employers' wage advance

¹ *Consummation* means the time that a consumer becomes contractually obligated on a new loan or a modification that increases the amount of an existing loan.

² 12 C.F.R. 1041.3

³ *Id.* Note that we use the term "balloon payment" to mean a repayment feature where one payment is more than twice as large as any other payment.

⁴ Leveraged payment mechanisms include any arrangements where a lender has the right to initiate a transfer of money from a consumer's account to satisfy an obligation on a loan, but does not include initiating a single immediate payment transfer at the consumer's request.

programs from the rule as well as no-cost advances.⁵ Further, the CFPB created a category of *alternative* and *accommodation* loans that are exempted from the rule's coverage so long as they meet certain conditions. First, alternative loans are those loans that are closed-end, have terms of one to six months, have principal amounts of \$200-\$1,000, are repaid in two or more substantially equal and fully amortizing payments, and do not include any charges not authorized under National Credit Union Administration regulations.⁶ This part of the rule allows credit unions, and creditors who make loans that share credit-union small-dollar loan features, to continue to make these short-term small-dollar loans without the burden of complying with the terms of the CFPB's rule.

While the alternative loan exemption allows for creditors to continue offering a certain product, the accommodation loan exemption serves to exempt a class of creditors from the rule's coverage. If a lender makes 2,500 or fewer covered loans in a calendar year, made 2,500 or fewer such loans in the prior year, and derived no more than 10 percent of their annual receipts from such loans, then the lender is exempt from this rule's coverage.⁷ Community banks and credit unions that make limited numbers of loans to their customers will not need to comply with this rule when issuing these loans.

Underwriting and Disclosure Requirements

Certain members of the financial services industry have requested that the CFPB define unfair, deceptive, and abusive acts and practices (UDAAP) through regulation, rather than enforcement. With this rule, the CFPB has taken steps to add clarity to the definition of unfair and abusive. Under 12 C.F.R. 1041.4, "it is an unfair and abusive practice for a lender to make covered short-term loans or covered longer-term balloon-payment loans without reasonably determining that the consumers will have the ability to repay the loans according to their terms."⁸ Additionally, under 12 C.F.R. 1041.7 it is an unfair and abusive practice for a lender to make attempts to withdraw payment from a consumers' accounts after two consecutive payment attempts result in a payment failure without first obtaining a new payment authorization from the consumer.⁹

Ability-to-Repay Determination

Prior to issuing a covered loan to a consumer, lenders will need to reasonably determine that a consumer can repay a loan in full while still meeting basic living expenses. Lenders may make that determination by calculating a borrower's debt-to-income ratio or residential net income and then reasonably concluding that the borrower can meet basic living expenses for the shorter of 45 days after consummation or the life of the loan, plus 30 days after the highest payment is due on the loan.

There are three core steps that lenders must follow to project consumer net income and payments due for major financial obligations. First, lenders must collect a written

⁵ 12 C.F.R. 1041.3(d)(7).

⁶ See 12 C.F.R. 1041.3. 12 C.F.R. 701.21(c)(7)(iii)

⁷ 12 C.F.R. 1041.3(f)

⁸ 12 C.F.R. 1041.4

⁹ 12 C.F.R. 1041.7

statement from the consumer regarding their income and expenses.¹⁰ Second, a lender must obtain verification evidence of the consumer's income and payments due for major financial obligations. Finally, a lender must obtain a national consumer report to verify a consumer's monthly debt obligations.

Lenders must attempt to obtain verification evidence of a consumer's income and may only reasonably rely on the consumer's written statement as evidence of income when reliable verification evidence is not available. For major financial obligations lenders must take into account any amounts listed in a consumer's written statement, even if verification evidence cannot be identified to support the expense listed in the written statement. Lenders may rely on the consumer's written statement regarding rental housing expenses when that expense is not reflected in a national consumer report.

Limited Underwriting Loans

While lenders must conduct a thorough ability-to-repay underwriting process for the covered loans mentioned above, lenders will not need to conduct the same review of a borrower's income and major expenses prior to issuing a loan with the following features: (1) fixed-rate; (2) fully amortizing; and (3) principal of less than \$500. Lenders must review only a consumer's borrower history in its own records, its affiliates' records, and a consumer report from a CFPB-registered information system prior to issuing these loans.¹¹ Under this limited underwriting exception, lenders may issue a second and third loan, in amounts not to exceed two-thirds and one-third of the initial loan respectively, without conducting additional reviews of a consumer's financial commitments. When issuing these loans, lenders may not take a security interest in a consumer's vehicle. Further, after issuing three such loans to a consumer, there must be a 30-day cooling off period where no further such loans are made to the consumer.

Disclosure Requirements

As an added safeguard to consumers who seek out the aforementioned limited underwriting loans, the CFPB has taken the familiar approach of requiring lenders to provide clear and conspicuous disclosures prior to consummation.¹² In appendices to the rule, the CFPB provides model forms that lenders must use, or substantially replicate, when issuing the first and third loans in a loan sequence. The requisite disclosures must be in writing, in a retainable format, and segregated from other materials provided to the consumer during the application process. The notices may be provided electronically, but must be formatted in machine-readable text that is accessible via web browsers and screen readers.

Payment Withdrawal Limitations

In addition to the underwriting standards, the rule contains a number of payment withdrawal protections aimed at protecting consumers from repeated collection attempts

¹⁰ 12 C.F.R. 1041.5(c)

¹¹ 12 C.F.R. 1041.6

¹² See 12 C.F.R. 1041.6(e)

that can lead to a pattern of insufficient funds fees or closure of the consumer's bank account. As an initial matter, the restrictions on payment withdrawals apply to short-term loans,¹³ longer-term balloon-payment loans,¹⁴ and longer-term loans with an APR greater than 36 percent that are repayable through a leveraged payment mechanism.¹⁵ The payment withdrawal restrictions apply to all covered loans, including longer-term installment loans that are otherwise exempt from the ability-to-repay standards discussed above.

Generally speaking, the restrictions apply to almost all lender-initiated transfers regardless of the payment method or type of transfer.¹⁶ Lenders are prohibited from initiating a third payment transfer from a consumer's account after the lender has attempted to initiate two consecutive failed payment transfers from the account.¹⁷ Thus, prior to initiating a third attempt, lenders must obtain either a new consumer authorization or a consumer authorization for a one-time transfer.¹⁸

Additionally, lenders must provide a series of consumer-friendly notices related to payment withdrawal, *i.e.*, the first payment (the "first payment withdrawal notice"), any unusual withdrawal (payments differing in amount, timing, payment channel, or initiated as a second present following a returned transfer -- the "unusual withdrawal notice"), and when the lender initiates two consecutive failed attempts (the "consumer rights notice").¹⁹ Similar to other CFPB rules, the Bureau has promulgated permissible notice forms for the scenarios described above. In this regard, compliance will be determined based on content, timing, and delivery method.²⁰ Of equal importance, lenders cannot take any action with the intent of evading the requirements of payment withdrawal restrictions.²¹

Reporting and Recordkeeping

The rule also establishes a new reporting regime for lenders originating covered short-term loans and covered longer-term balloon payment loans through the creation of the Registered Information System (RIS), which has not yet been created.²² As a general matter, lenders will be required to furnish loan level data to the RIS at the time of origination, during servicing and when changes in a consumer's circumstance arise, and at the time of satisfaction/termination.²³ Lenders are subject to a 36-month record retention policy that applies to each covered short-term loan, covered longer-term balloon payment loan, and covered longer-term loan. Consumer applications, underwriting documentation, consumer statements, disclosures, loan agreements,

¹³ 12 C.F.R. 1041.3(b)(1).

¹⁴ 12 C.F.R. 1041.3(b)(2).

¹⁵ 12 C.F.R. 1041.3(b)(3).

¹⁶ 12 C.F.R. 1041.8(a)(1)(i) and (ii).

¹⁷ 12 C.F.R. 1041.8(a)(1)(ii).

¹⁸ 12 C.F.R. 1041.8(c)(1).

¹⁹ See 12 C.F.R. 1041.9.

²⁰ See *e.g.*, 12 C.F.R. 1041.8(c)(3)(ii), 1041.9(b)(2)(i).

²¹ 12 C.F.R. 1041.8(e).

²² See 12 C.F.R. 1041.10(a).

²³ See 12 C.F.R. 1041.10(c).

required notices, and payment authorizations should all be retained as primary evidentiary support for compliance with the rule.

Timing

The RIS component of the rule is scheduled to take effect 60 days after publication in the Federal Register. The remainder of the rule, including the ability-to-repay and payment withdrawal provisions, will become effective 21 months after publication – in the summer of 2019. There are a number of events, however, that may delay or thwart the implementation of this rule. Financial services providers and their trade associations are likely to encourage Congress to disapprove of the rule through the Congressional Review Act. If Congress fails to secure the votes to overturn the rule, then the industry will likely pursue legal challenges to keep this final rule from going into effect. Finally, since the effective date of the rule is beyond the expiration of CFPB Director Richard Cordray’s term, there is certainly a possibility that the CFPB’s next director will take steps to delay, scale back, or eliminate the rule.

Final Takeaway

Like the mortgage origination and servicing rules previously issued by the CFPB, this rule will dramatically change the paradigm for small-dollar lenders. To prepare for implementation, participants in the industry will need to develop new policies and procedures, draft new underwriting guidelines, train staff, identify appropriate third-party vendors, and interface with reporting agencies. To that point, it will be critical for lenders to establish a robust compliance monitoring system (CMS). Even if the rule does not take effect as scheduled, the CFPB’s rulemaking provides the industry with insight into what the CFPB considers underwriting and payment processing best practices for participants in the small-dollar lending industry.

For more information about the topics raised in this white paper, please contact [Nathan P. Viebrock](#) or [Preston H. Neel](#).