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Payday Lenders, Vehicle Title Loans, and Small-Value Financing: The CFPB's Proposal to Regulate the Fringe Economy

Christopher K. Odinet*

The U.S. Consumer Financial Protection Bureau recently released a report outlining the agency's long heralded plans to impose nationwide regulations on the fringe economy. The first part of this article gives an overview of the fringe economy, the types of services and products it provides, and gives a snapshot of existing, state-based regulations. The second part goes into the nuts and bolts of the proposed rules.

The market for payday lenders, businesses that provide vehicle title loans and other small-value financing players, is rife with controversy.[1] Some see them as predatory lenders that weave a web of never-ending debt designed to capture the weakest and most economically vulnerable of society.[2] However, advocates of these financial institutions argue that for many Americans who are otherwise shut out of the conventional lending market, these players provide the only viable source of credit in times of economic hardship.[3] Whatever the view, these businesses, their borrowers, and the credit markets that they together comprise are often referred to in legal and economic research and literature as the "fringe economy."[4]

Reams of paper have been used by think tanks, advocacy groups, lawyers,

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[1] *See* Yolanda Young, *'Fringe Economy' Preys on the Poor*, USA TODAY, Jan. 26, 2006; *see also* Jessica Silver-Greenberg, *Payday Lenders Go Hunting*, WSJ, Dec. 24, 2010.

[2] Ellen E. Schultz & Theo Francis, *High-Interest Lenders Tap Elderly*, Disabled, WSJ, Feb. 12, 2008; Carter Dougherty, *Payday Lenders Evading Rules Pivot to Installment Loans*, BLOOMBERG NEWS, May 29, 2013, http://www.bloomberg.com/news/articles/2013-05-29/payday-lenders-evading-rules-pivot-to-installmant-loans.

[3] FEDERAL DEPOSIT INSURANCE CORPORATION, FDIC NATIONAL SURVEY OF UNBANKED AND UNDERBANKED HOUSEHOLDS 10 (2009).

[4] HOWARD KARGER, SHORTCHANGED: LIFE AND DEBT IN THE FRINGE ECONOMY 4–15 (2005).

public policy analysts, and (of course) law professors in producing a vast body of scholarship and research seeking to address the manifold issues surrounding the fringe economy.[5] State houses across the country have been battlegrounds for efforts to restrict or protect (or a mix of both) the members of the fringe economy.[6] And due to varying successes in different jurisdictions across the U.S., combined with a lack of movement at the federal level, the fringe economy has been and remains subject to a disjointed, patchwork system of rules and regulations.[7]

However, on March 26, 2015 the U.S. Consumer Financial Protection Bureau (the "CFPB" or the "Bureau") released a report outlining the agency's long heralded plans to impose nationwide regulations on the fringe economy.[8] What follows is by no means a comprehensive commentary on this report or the rules that will ultimately come out of it. It is still rather early in the game. The reason for the existence of the Bureau's report itself is due to the agency's preliminary work stemming from the little known Small Business Regulatory Enforcement Act ("SBREFA").[9] Prior to engaging in the more formalized rulemaking process, SBREFA (and portions of Dodd-Frank)[10] requires that if the Bureau intends to enact rules that will have a significant economic impact on certain small business (as defined in the act), then the Bureau must first

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[5] MELVIN OLIVER & THOMAS M. SHAPIRO, BLACK WEALTH / WHITE WEALTH: A NEW PERSPECTIVE ON RACIAL INEQUALITY (2006); PETER UTTING, SOCIAL AND SOLIDARITY ECONOMY: BEYOND THE FRINGE? (2015); Creola Johnson, *Payday Loans: Shrewd Business or Predatory Lending*, 87 MINN. L. REV. 1 (2002); Ronald J. Mann, *After the Great Recession: Regulating Financial Services for Low-and Middle-Income Communities*, 69 WASH. & LEE L. REV. 729 (2012); Sarah Howard Jenkins, *Fringe Economy and Other Aberrant Contract: Introduction*, 89 CHI.-KENT L. REV. 3 (2014).

[6] Easha Anand, *Payday Lenders Back Measures to Unwind State Restrictions*, WSJ, Oct. 28, 2008; Alan Zibel, *Lawsky Pushes for Strict Payday Loan Rules*, WSJ, Feb. 5, 2015.

[7] Nathalie Martin, *1,000% Interest—Good While Supplies Last: A Study of Payday Loan Practices and Solutions*, 52 ARIZ. L. REV. 563 (2010); Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961 (2008); Paige Marta Skiba, *Regulation of Payday Loans: Misguided?*, 69 WASH. & LEE L. REV. 1023 (2012).

[8] *See* Small Business Advisory Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered (March 26, 2015), *available at* http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf [hereinafter "CFPB Proposal"]. The legal authority for the agency's ability to regulate this area of the financial market is asserted under Section 1031 and Section 1032 of the Dodd-Frank Act. *See* 12 U.S.C. § 5531(b), 5532(a) (2015).

[9] *See* 5 U.S.C. § 609(b) (2015).

[10] 5 U.S.C. § 603(d) (2015).

consult with a panel representing these small financial service providers early in the process.[11] The report issued on March 26 was meant to provide a guide to the panelists as they engage in this consultative process.

The first part of this article gives an overview of the fringe economy, the types of services and products it provides, and gives a snapshot of existing, state-based regulations. The second part goes into the nuts and bolts of the proposed rules. This part is broken up into four subparts. The first deals with the rules that will govern short term loans, the second addresses those regulations for longer term loans, and the final two highlight the administrative aspects of the proposal—how debt may be collected and what types of record-keeping are required. Although the final promulgated rules may deviate from the proposals in the report that is summarized below, one can easily surmise that an understanding of these initial proposals can be quite useful in gaining a better appreciation of the CFPB's general intentions and an idea of how counsel for fringe economy lenders might best advise their clients going forward.

OVERVIEW OF THE FRINGE ECONOMY

Before understanding the current proposals (as well as what motivated the CFPB in crafting them), it is necessary to understand exactly what comprises the so-called fringe economy. This includes knowing something about the services and products that are offered, as well as the current legal and regulatory regimes that affect them.

First, the breath and scope of the fringe economy is typically under appreciated.[12] As one commentator notes, the use of the term "fringe" is a bit of a misnomer.[13] It implies smallness and relative insignificance, but that is in fact far from the truth. About 30 million people in the U.S. turn to the fringe economy for credit,[14] and "there are more payday lending and check-cashing outlets in the United States than McDonald's, Burger King, Target, Sears, JCPenney, and Wal-Mart locations combined."[15]

Financial Products and Services

Generally, "payday lenders, pawnshops, rent-to-own stores, auto-title lend-

[11] For a listing of those groups represented on the panel see CFPB Proposal, *supra* note 9, at 5.

[12] *See* Jim Hawkins, *The Federal Government in the Fringe Economy*, 15 CHAP. L. REV. 23 (2011).

[13] *See id.* at 3–4.

[14] *Id.*

[15] *See* KARGER, *supra* note 5, at 4.

ers" and other short-term, low-value lenders populate the landscape of the fringe economy.[16] They are very often the only places that many Americans can turn when the need for credit arises and options with mainstream banks and credit unions are unavailable.[17]

Perhaps the most prevalent of the fringe economy players are payday lenders, which first appeared on the scene in the early 1990s.[18] Although not explicitly stated, the CFPB's proposal appears to be—at least to some extent—focused on the activities of these particular entities and those that provide similar services.[19] These are companies that provide small dollar loans—typically in the neighborhood of $100 to $500 (and even up to $1,000)—with a term of repayment being roughly anywhere from two weeks to one month.[20] Because the transactions are typically quite small, a high volume is necessary in order for the business to be profitable.[21] There are about 20,600 payday loan stores in the U.S. that collectively provide $38.5 billion in loans to about 19 million borrowers.[22] And of these players, about a handful wield the most influence. About 20 percent of the total market share is controlled by six payday lending companies—Advance America, Cash America, ACE Cash Express, Inc., Check n Go, Dollar Financial, and Check Into Cash.[23] Even a number of mainstream lenders like Wells Fargo and U.S. Bank provide services similar to those offered by these payday giants.[24]

Other prominent players in the fringe economy are rent-to-own companies, which began around the 1960s.[25] These entities provide a way for consumers

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[16] *See* Hawkins, *supra* note 13, at 23.

[17] *See id.*

[18] Michael H. Anderson, *An Economic Perspective on Subprime Lending*, 89 CHI.-KENT L. REV. 53, 58–59 (2014).

[19] *See* CFPB Proposal, *supra* note 9, at 1; *see also* Press Release: CFPB Considers Proposal to End Payday Debt Traps, March 26, 2015, http://www.consumerfinance.gov/newsroom/cfpb-considers-proposal-to-end-payday-debt-traps/.

[20] *See* Anderson, *supra* note 19, at 58–59 (citing Cash Advance Rates / Fees, Cash Am. Int'l, Inc., http://www.cashamerica.com/LoanOptions/CashAdvances/RatesandFees.aspx (providing a state-by-state listing of fees)).

[21] *Id.*

[22] *Id.* (citing About the Payday Advance Industry, Cmty. Fin. Servs. Ass'n of Am., http://cfsaa.com/about?thepaydayindustry.aspx).

[23] *Id.* (citing Michael A. Stegman, *Payday Lending*, J. OF ECON. PERSP. 169, 172 (2007)).

[24] *Id.* (citing Direct Deposit Advance Frequently Asked Questions, Wells Fargo, https://www.wellsfargo.com/checking/direct-deposit-advance/faqs/).

[25] *Id.* at 55–57 (citing The Rent to Own Industry: An Overview, Ass'n of Progressive Rental

to purchase goods—usually in the form of household appliances, furniture, or media systems—through an installment payment plan.[26] The frequency of the installments, however, is at the choosing of the borrower (weekly, monthly etc.).[27] Thus, a consumer who is only paid once a month can arrange for his rent-to-own payments to be aligned with his paydays, with the total term ranging anywhere from one year to 24 months.[28] During the entire installment period the "borrower" can return the good and terminate the agreement at any time.[29] The industry generates about eight and a half billion dollars a year, with its biggest players being Rent-A-Center and Aaron's (both of which are publicly traded).[30]

Other fringe economy providers include pawn brokers and vehicle title loans.[31] With pawn dealers, the borrower is given a loan and, in return, hands over to the broker an item of personal property to serve as collateral (the borrower can directly sell the property to the pawn business as well).[32] There are over 10 thousand pawnshops in the U.S., with market share being splintered among a large number of independent businesses.[33] Generally the loan is about $150 and the term for repayment is about one to two months.[34] Once the loan is repaid, the borrower gets his item of personal property back.[35] However, the interest rates on these loans are high—as much as 25 percent in a number of places.[36] These loans tend to be very popular because they are collateral-based, thus alleviating the need for any individual-based underwriting, and because a

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Orgs., http://www.rtohq.org/about-rent-to-own/; Michael H. Anderson, Rent-to-Own Lending, in Consumer Survival: An Encyclopedia of Consumer Rights, Safety, and Protection (2013)).

[26] *See id.*

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.* (citing Michael H. Anderson & Raymond Jackson, *Managing High Risk in a Retail Operation: The Rent to Own Business*, 29 The Southern Business & Economic Journal 87, 89, 97 tbl. 4 (2006); Michael H. Anderson & Sanjiv Jaggia, *An Empirical Look at Low Income Consumers and the Rent To Own Industry*, in Low Incomes: Social, Health, and Educational Impacts 245, 248 (2009)).

[31] *Id.* at 59–63.

[32] *Id.* at 59–61.

[33] *Id.* (citing Pawn Industry Overview 2013, Nat'l Pawnbrokers Ass'n 4, *available at* http://assets.nationalpawnbrokers.org/2010/10/NPA-Industry-Overview-2013-ln031913.pdf).

[34] *Id.*

[35] *Id.*

[36] *Id.*

default does not reflect negatively on the borrower's credit report.[37]

The last of the major fringe economy players are vehicle title loan lenders—which are actually on the rise.[38] These businesses provide relatively small value loans that are secured by a lien on the borrower's personal vehicle.[39] Unlike many of the other loans discussed above, the size of the loan and length of the term can vary from "$300 for thirty days" to "$5,000 for a year or more."[40] Like pawn loans, the borrower's credit worthiness generally does not play a part in the underwriting analysis. Rather, the loan is collateral-based.[41] In this industry there are a number of large market players such as TitleMax and Auto Cash USA, as well as a host of small lenders.[42]

Current Regulatory Environment

There are currently no federal laws targeted at regulating fringe economy service providers.[43] Some states and the District of Columbia have a variety of different laws affected the industry, but they are hardly uniform.[44] For instance, payday lenders are regulated in about 40 states and Washington D.C. where fees are limited, the frequency of such loans to the same borrower are restricted, and the loan amount is capped.[45] In a small number of other states, however, the rules governing this industry are so stringent that payday lending has been practically eliminated.[46]

Similarly, rent-to-own companies are also not subject to federal regulations. Rather, 47 states individually regulate these services that comprise a mix of disclosure requirements and limitations on fees and ancillary charges.[47] With respect to pawnbrokers (also not federally regulated), many jurisdictions impose interest rate caps and a number of reporting and record keeping requirements

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[37] *Id.*

[38] *Id.* at 61–63.

[39] *Id.*

[40] *Id.*

[41] *Id.*

[42] *Id.*

[43] Josh Boak, *How Gov't Aims to Protect Low-Income Users of 'Payday' Loans*, ABCNEWS, Mar. 26, 2015 ("The government is seeking to set standards for a multibillion-dollar industry that has historically been regulated only at the state level.").

[44] David Dayen, *The Government Is Finally Cracking Down on Legal Loan Sharks*, FISCAL TIMES, Mar. 27, 2015.

[45] *See* Anderson, *supra* note 19, at 57–58.

[46] *See id.*

[47] *Id.* at 56–57.

to guard against theft.[48] Further, a small number of states require that, in the event of a default and a disposition of the collateral, that any excess proceeds from the sale be returned to the borrower (thus preventing a windfall to the lender).[49] Lastly, vehicle title loans, while not federally regulated, are regulated to some extent by most states, although these regulations differ greatly from place to place.[50] In some states the practice is banned (mostly in the New England area) while in other states there is a limit to the amount of the loan (like Illinois, Mississippi, and Tennessee).[51] Certain jurisdictions exempt these loans from normal usury limitations.[52]

THE PROPOSED REGULATORY FRAMEWORK

The CFPB's proposed regulatory framework can be broken down into four parts. The first two deal with specific rules that will govern certain types of financial products.[53] These more substantive provisions create a system of underwriting requirements that are somewhat similar to the "Ability-to-Repay" rules found in the new mortgage origination regulations that went into effect on January 10, 2014.[54] The next two parts are more administrative in nature and place limitations on how certain types of consumer debt can be collected, as well as impose record-keeping compliance requirements on certain fringe economy lenders.[55]

Notably, the CFPB is not currently engaged in plans to regulate credit cards, student loans, real estate-backed loans, deposit account overdraft services, or non-recourse pawn loans where the lender takes possession of the collateral and the term for repayment is 45 days or less in duration.[56] Although one might surmise that as some of these items gain more public and political attention—

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[48] *Id.* at 61 (citing John P. Caskey, *Pawnbroking in America: The Economics of a Forgotten Credit Market*, 23 J. OF MONEY, CREDIT, AND BANKING, 85, 88–89 (1991)).

[49] *See id.* (citing Joshua D. Shackman & Glen Tenney, *The Effect of Government Regulations on the Supply of Pawn Loans*, 30 J. OF FIN. SERVS. RES., 69, 80–82 (2006)).

[50] *Id.* at 63 (citing Amy Biegelsen, Credit Bureaus, Auto-Title Lenders, Debt Collectors Among Priorities of New Consumer Agency, Center for Pub. Integrity (June 23, 2011, 1:18 PM), http://www.publicintegrity.org/2011/06/23/4996/credit-bureaus-auto-title-lenders-debt-collectors-among-priorities-new-consumer.).

[51] *Id.*

[52] *See id.*

[53] *See* CFPB Proposal, *supra* note 9, at 7–28.

[54] 12 C.F.R. § 1026 (2015).

[55] *See* CFPB Proposal, *supra* note 9, at 28–31.

[56] *See id.* at 4–5.

particularly student loan debt—the CFPB may turn its attention to these financial products and services, currently it is not intended that they be affected.[57]

New Rules for Short-Term Loans

The first set of rules deals with loans of a relatively short duration.[58] The argument the Bureau makes is that although these loans can theoretically be of some value to borrowers in the immediacy, they ultimately end up not being in the borrower's long-term interest.[59] Specifically, they encourage frequent reborrowing by the already financially weak consumer.[60] To that end, the restrictions provided below, mostly in the way of mandatory underwriting standards, are being proposed.[61]

What Transactions Are Covered?

Short term loans are defined as consumer loans with a duration of 45-days or less (called "covered short term loans"). Although such a loan will be covered, regardless of how it is denominated by the lender, the CFPB includes among these products

(1) payday loans that require a single payment;

(2) loans that require multiple payments with the full amount due in 45 days;

(3) vehicle title loans; and

(4) revolving lines-of-credit where the credit line terminates in 45 days or becomes due in full within 45 days.[62]

The bureau explains that the reason for the 45-day limitation is to capture those products that require payment during a single paycheck cycle.[63] Since borrowers are subject to varying pay cycles that can be as short as one week or as long as one month, the CFPB chose 45-days so as to take into account those loans made right before a paycheck is issued and thereby might exceed a single

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[57] *See id. see also* Shahien Nasiripour, *Consumer Regulator Vows Action As Student Loan Borrowers Suffer*, HUFFINGTON POST, Oct. 16, 2014.

[58] CFPB Proposal, *supra* note 9, at 7.

[59] *See id.*

[60] *Id.* at 9–10.

[61] *See id.*

[62] *Id.* at 7.

[63] *Id.*

month period.[64]

Determining the Ability-to-Pay

Once one determines that product being offered to the consumer is covered, a mandatory underwriting analysis is triggered.[65] The rules that will govern this underwriting processes have two parts. First there is a substantive analysis portion of the inquiry, and secondly there is a procedural burden shifting aspect.

Substantive Requirements

The lender would be required—much like with mortgage origination loans—to assess the borrower's ability-to-repay the loan.[66] Such a determination must meet the usual standards of good faith and reasonableness, but it must also specifically assess whether the borrower has the financial means necessary to retire the debt being undertaken, while still having sufficient funds for living expenses and major financial obligations.[67]

First, the lender would analyze the borrower's income basis, verified through bank statements, paystubs, and the like.[68] Second—and perhaps more complex—the lender would also be required to review the borrower's existing major financial obligations, examples of which include mortgage and insurance payments or rent, but, based on the Bureau's continued deliberations, may also include other frequently occurring expenses like medical costs and utility payments.[69] The process by which lenders can verify these major financial obligations is still under consideration.

Second, the lender must assess the borrower's credit history.[70] A number of proposals are being considered. For instance, one option involves the lender being required to obtain information about the borrower from its affiliate lenders (a practice that is likely already occurring), as well as a requirement that the lender obtain information about the borrower from all lenders during the most recent 18-month period.[71] Since this process can be more difficult in that non-affiliated lender information may be difficult to obtain, the CFPB is

64 *See id.*

65 *Id.* at 11–16.

66 *Id.*

67 *See id.*

68 *Id.*

69 *See id.* at 11–12.

70 *See id.* at 12–13.

71 *Id.*

considering criteria for the establishment of covered short term loan reporting databases that can serve as a resource for lenders in obtaining this broader category of borrower credit history.[72] Any such database or service would not, however, be operated or contracted for by the CFPB.[73]

Lastly, the borrower must take into the account the borrower's necessary living expenses.[74] Despite going into great depth in explaining what might be involved in analyzing the borrower's major financial obligations, the Bureau has given little information on what should be included (and to what extent) in the living expenses analysis.[75] The proposal mentions food and transportation costs,[76] but would this also include an allowance for clothing, educational expenses, and other incidentals? It would appear that utilities and housing costs would not be included, since they are listed in the report as examples of "major financial obligations."[77] Additional elaboration would be helpful with regard to this factor, particularly as it relates to what is considered "necessary"[78] since such expenses need not be itemized or verified by the lender.[79]

After obtaining information in connection with these three factors, the analysis of the borrower's ability-to-repay must be not only for the term of the loan, but also for an additional 60-days after the term has ended (this is collectively known as the "underwriting period").[80] The purpose of the additional 60-days is to ensure that even after the debt is retired that the household income cycle of the borrower will be sufficient to support ongoing major financial obligations and living expenses.[81]

Procedural Implications

In the context of the ability-to-repay analysis, the bureau is contemplating incorporating two procedural presumptions. First, if the borrower at issue (1) has taken out another covered short-term loan due within the past 60 day period or (2) has a covered longer term loan (defined below) with a balloon

[72] *See id.*

[73] *Id.*

[74] *Id.* at 11.

[75] *Id.*

[76] *Id.*

[77] *See id.*

[78] *Id.*

[79] *See id.* at 14.

[80] *Id.* at 13–14.

[81] *See id.*

payment due within the past 60 day period, then any new covered short term loan will be presumed to run afoul of the borrower's ability-to-repay.[82] This is premised on the notion that reborrowing of similar short-term products within short intervals is indicative of a weak financial position, and thus vulnerability and a likelihood of default.[83] That is not to say, however, that this presumption cannot be overcome. Rather, if the lender can show that the borrower's financial position has changed since the issuance of the first covered short term loan—through increased financial resources, a pay raise, or retirement of other non-short term debt—then the additional short term product can still be issued and not be in contravention of the ability-to-repay restrictions. Such a change in circumstances, however, would require independent verification.[84]

However, the CFPB's other presumption, if implicated, is conclusive and irrebuttable.[85] Under this second presumption the borrower is *per se* considered to be unable to repay if three successive covered short term loans (or covered longer term loans with a balloon payment, or any combination thereof) are made to the same borrower.[86] Regardless of any change in financial circumstances to the benefit of the borrower, the new rule would require a cooling off period, without exception, after two consecutive short term loans were made to the same individual.[87]

Revolving Lines of Credit Assumptions

Lastly, for those covered short term loans that consist of revolving lines of credit where the loan terminates within 45-days or the loan is due in full in 45-days, the CFPB may impose a number of additional underwriting assumption on the lender in making his determination.[88] One such proposal under consideration is that the lender assume that the borrower will draw down the entire amount on the revolving line of credit at the time the loan is made and that he will only make minimal payments throughout the term, with the remaining balance being paid in full at the end. More information on covered revolving line of credit loan underwriting is still yet to come.[89]

82 *Id.* at 15–16.

83 *Id.*

84 *See id.*

85 *Id.*

86 *Id.*

87 *Id.*

88 *Id.* at 16.

89 *Id.*

Safe Harbor Provisions and Open Issues

One of the issues on which the CFPB seeks input deals with whether lenders should have an avenue to make these covered short term loans without the need to assess the borrower's ability-to-repay.[90] Since the process of making such an assessment will necessarily involve a level of subjectivity and discretion—which in turn can lead to risk and regulatory exposure—and add to the cost of compliance, it makes sense to provide a safe harbor.[91]

As an initial matter, some of the safe harbor "screening" provisions would include

(1) verification of the borrower's income (which is already a requirement under the general ability-to-repay requirement);

(2) the lender verifying the borrower's credit history and reporting the issuance of the loan to all applicable reporting services;

(3) ensuring that the borrower has no other covered short or longer term loan with any lender;

(4) certifying that the borrower has not engaged in more than three "safe harbor" loans in a sequence, nor obtained three "safe harbor" loans from any lender in the past 60-days;

(5) after retirement of the third loan in a sequence, promising not to extend additional credit to the borrower, of any sort, within a 60-day period;

(6) verifying that the issuance of the "safe harbor" loan will not result in the borrower incurring more than six covered short term loans in any single 12-month period; and

(7) taking into account the term of the safe harbor loan, ensuring that the borrower will not be in debt on covered short term loans for more than 90-days during a single 12-month period.[92]

By meeting these "screening" requirements, the borrower's loan, despite being a covered short term loan, may nevertheless be deemed a safe harbor loan (and hence be relieved from meeting the ability-to-repay analysis) but only if three additional loan limitations or design features are met.[93] The loan (1) must be limited to $500 and have a duration of no more than 45-days (allowing for

[90] *Id.* at 16–18.

[91] *Id.*

[92] *Id.* at 17.

[93] *Id.*

only one finance charge); (2) cannot be secured by a lien on the borrower's vehicle; and (3) must be structured so as to cause the consumer's indebtedness to decline over the life of the loan.[94] This final "tapering off" requirement might be achieved, under the CFPB's current proposals, by (1) the lender providing certain no cost "off-ramp" extended payment plans for borrowers who cannot repay the debt; or by (2) principal reduction and amortization adjustment clauses for loans in a sequence.[95] Which of these two methods the CFPB will ultimately adopt is subject to ongoing comment.

New Rules for Longer Term Loans

The second type of loan product that would be covered by these new rules comprise loans of a longer duration and that entail certain predatory features.[96] Much of the reason for this rests on the same concerns articulated by the CFPB in the context of short term loans.[97] Specifically, that long-term financial harm can result from these products.[98] This is particularly the case because the longer term loans that the Bureau is concerned with are those where the borrower's vehicle serves as collateral or where the lender has direct access to the borrower's checking account funds for purposes of obtaining repayment.[99] The CFPB admits in its proposal that it intends only to capture a small number of transactions that form part of the larger "installment lending market" but that further rulemaking, and perhaps even a non-depositary lending institution registry, may occur in the near future.[100]

What Transactions Are Covered?

Longer term loans are defined by those products with a term of longer than 45-days with a cost of credit rate that is greater than 36-percent where the lender either (1) has direct access to be repaid through the borrower's checking account or paycheck; or (2) has a non-purchase money lien on the borrower's motor vehicle (called "covered longer term loans").[101] Access to such a deposit account could come in the form of a post-dated check, an ACH authoriza-

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[94] *Id.*

[95] *Id.*

[96] *Id.* at 19–21.

[97] *Id.* at 21–22.

[98] *Id.*

[99] *Id.*

[100] *Id.*

[101] *Id.* at 19.

tion,[102] an RCC authorization,[103] an automatic debit to prepaid card, a payroll deduction, or some other method of collecting from a borrower's deposit accounts.[104]

In order to exclude certain longer term loans for which the CFPB is not concerned with, a cost threshold is under evaluation.[105] The cost of credit threshold most likely to gain final favor with the Bureau is the so-called military annual percentage rate, which accounts for not only interest but also fees and expenses in connection with products related to the loan, such as memberships, insurance, or debt cancellation agreements.[106] Rather than merely use an annual percentage rate, this more expanded costs of credit rate would include add-on fees, however denominated, that can often result in the financial burden of the loan being far greater than what the mere annual rate would suggest.[107]

Determining the Ability-to-Pay

As with covered short term loans, the CFPB is also considering incorporating an ability-to-repay component to covered longer term loans. Once again, the lender would have to engage in an underwriting exercise that requires it to make a reasonable and good faith determination that the borrower can indeed repay the loan.[108] Likewise, the lender also has to deal with a procedural aspect to this inquiry that involves evidentiary presumptions.[109]

Substantive Requirements

The substantive ability-to-repay inquiry will involve the familiar evaluative

[102] *Romano-Murphy v. C.I.R.*, T.C. Memo. 2012-330 (2012) ("The Automated Clearing House is a funds transfer system that "provides for the interbank clearing of electronic entries for participating financial institutions." *Id.* An Automated Clearing House debit entry is "a transaction in which one of the Treasury Financial Agents, upon instructions from a taxpayer, instructs the taxpayer's financial institution to withdraw funds from the taxpayer's account for an FTD or FTP [federal tax deposit or federal tax payment] and to route the FTD or FTP to the appropriate [Department of the] Treasury account through the ACH [Automated Clearing House] system.").

[103] *See generally* 12 C.F.R. § 229.2(fff) (2015) ("[A] remotely created check means a check that is not created by the paying bank and that does not bear a signature applied, or purported to be applied, by the person on whose account the check is drawn.").

[104] *Id.*

[105] *Id.*

[106] *Id.* (citing 32 C.F.R. § 232 (2015)).

[107] *Id.*

[108] *Id.* at 22–24.

[109] *Id.* at 24–25.

factors of the borrower's income and major financial obligations, as well as the individual's credit history on all covered loans (whether short or longer term).[110] Although living expenses is not mentioned directly in the analysis of longer term loans,[111] it is arguably encapsulated in the definition of major financial obligations, judging from later parts of the CFPB's proposal dealing with longer term loans.[112] The parameters and more detailed nuances of how the lender engages in this analysis are precisely the same as those set forth above for covered short term loans.[113] Notably, however, the refinancing of certain loans into covered longer term loans would be subject to the ability-to-repay inquiry.[114]

However, what the CFPB argues is somewhat different from the short term loan analysis involves looking at how the lender, when confronted with the three categories of information set forth above, reaches its reasonable and good faith determination that the borrower can indeed repay the loan.[115] Specifically, the CFPB directs the longer term loan lender to use a residual income analysis whereby the lender determines that (1) the timing of the receipt of income to the borrower; and (2) the payment of major financial obligations and living expenses throughout the term of the loan, support the conclusion that the borrower has the ultimate ability to repay while still maintaining general financial health.[116] However, in reviewing this directed analysis, there are admittedly few (if any) real differences between how the longer term lender reaches its good faith and reasonable determination of the borrower's ability-to-repay and how the short term lenders reaches the same conclusion.[117]

Procedural Implications

The procedural aspects of the inquiry, however, are somewhat different and

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110 *Id.* at 22–24.

111 *Id.* at 22.

112 *Id.* at 22 ([T]he Bureau would require lenders to obtain and verify certain financial information about the consumer in order to make a reasonable determination about the consumer's ability to repay the contemplated loan. This information would include three components: the consumer's (1) income, (2) major financial obligations, and (3) borrowing history on covered loans."); *cf.* ("This determination would require the lender to find that a consumer is able to make all projected payments under the covered longer-term loan as those payments are due while still fulfilling her other major financial obligations and meeting *living expenses*.") (emphasis added).

113 *Id.* at 22–23.

114 *Id.*

115 *Id.* at 23–24.

116 *Id.*

117 *Id.*

can be initially broken down into two presumptions.[118] The first deals with refinancing and the second deals with loans that require balloon payments.[119]

The first presumption (dealing with refinancing) requires the lender to engage in a two step process. First, it must determine whether the covered longer term loan is eligible for the presumption, and then, after making this determination, it must ascertain whether the borrower has the requisite features to trigger the presumption.[120] As to the initial "eligibility" inquiry, there are two possibilities. First, if a borrower seeks to refinance his debt (whether or not that debt is in connection with a covered loan) into a longer term loan *with the same lender or with one of the original lender's affiliates*, then there is a presumption that the borrower fails to meet the ability-to-repay.[121] Second, if a borrower seeks to refinance a covered loan from *any lender* into a covered longer term loan, then there is also a presumption that the borrower fails to meet the ability-to-repay rule.[122] The Bureau's rationale is that in such situations it is almost always the case that the borrower, who lacked the ability to repay the initial loan, will most likely lack the ability to repay the refinanced covered longer term loan as well.[123]

Once the lender determines that the refinanced or extended, covered longer term loan would be eligible, the analysis turns to a specifically delving into the particular circumstances of the borrower to see if the trigger is met.[124] In order for the presumption to apply to the eligible loan, then at least one the following must occur, either in the extension of the existing loan or in the refinancing of said loan:

(1) the consumer, at the time of refinancing, must be currently or at least recently delinquent on a payment under the loan being refinanced;

(2) the borrower attests that the she is unable to make payment under the current loan or that having to make payment under the current loan is causing financial distress;

(3) the refinanced loan provides that the borrower will enjoy making a payment in a lesser amount than what was due under the original

[118] *Id.* at 24–25.

[119] *Id.*

[120] *Id.*

[121] *Id.* (emphasis added).

[122] *Id.* (emphasis added).

[123] *Id.*

[124] *Id.*

loan (cash-outs being excepted); or

(4) the loan is in default.[125]

Once the lender goes through the admittedly extensive process of determining whether the refinancing at issue is eligible and whether the presumption is triggered, it may then rebut the presumption by verifying a change in the financial circumstances of the borrower that would evidence that she has the ability-to-repay the extended new loan or the new/refinanced loan.[126]

The second presumption deals exclusively with covered longer term loans where a balloon payment—with such a payment being one that is more than twice the amount of a regular periodic payment—is due by the borrower during the term.[127] With these types of covered longer term loans, the lender would be required to conduct an underwriting inquiry into the borrower's income and major financial obligations for an additional 60-days after the end of the term of the loan.[128] And as with the proposed rule for covered short term loans, there would be an additional presumption involved where a borrower attempts to reborrow within 60-days after taking out a covered longer term loan that includes a balloon payment (or a covered short term loan, or any combination thereof).[129] In such an event the lender would have to make a good faith, reasonable determination that the borrower could indeed repay the new loan based on a change in circumstances.[130] In the event the lender cannot, he will be prevented from making the additional covered longer term loan with a balloon payment or even a covered short term loan until the 60-day cooling-off period has passed.[131]

Revolving Lines of Credit Presumptions

Last, but certainly not least, the CFPB proposes to attach specific considerations to those covered longer term loans that take the form of open-ended lines of credit. Here again, certain automatic assumptions would apply to the lender's review.[132] Specifically, the lender would have to assume that the borrower draws down the entire amount available under the loan at the time of its issuance and

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125 *Id.*

126 *Id.*

127 *Id.* at 25.

128 *See id.*

129 *Id.*

130 *Id.*

131 *Id.*

132 *Id.*

that she will make only the minimum payments during the term of the loan, with all outstanding amounts due being paid by a single payment at the end.[133] If the term of the line of credit is not stipulated, the Bureau is considering incorporating a 6-month from origination presumption on the lender for purposes of these assumptions.[134]

Safe Harbor Provisions and Open Issues

Just as with covered short term loans, the CFPB is interested in creating a safe harbor-type provision that would allow lenders to otherwise make such loans without the need to deal with the ability-to-repay determination and the various presumptions pertaining to refinancings and balloon payment loans.[135] By providing such a safe harbor, the CFPB hopes to reduce compliance costs associated with the more involved ability-to-repay analysis—particularly as it relates to small lenders who have fewer resources—and maintain access to credit, while at the same time protecting consumers.[136]

One such safe harbor would be for those covered longer term loans that meet the requirements of loans issued pursuant to the U.S. National Credit Union Administration ("NCUA")'s Payday Alternative Loan program.[137] If adopted the safe harbor, however, would not be limited to merely credit unions.[138] Loans under the NCUA program must meet two prongs: one involves a screening exercise whereby the lender uses minimum underwriting standards and verifies the income of the borrower, and the other involves structural designs whereby the loan's principal amount is limited to a range of $200 to $1,000, has a maximum repayment term of six months, the annualized interest rate is restricted to 28 percent (with a capped application fee of $20), and the loan is fully amortized over at least two payments.[139]

In addition to the above NCUA loan parameters, the CFPB is considering

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[133] *Id.*

[134] *Id.*

[135] *Id.* at 26–28.

[136] *Id.* at 26 ("The Bureau is considering whether offering such alternative requirements for lenders—including small lenders that may have difficulty conducting an ability-to-repay determination with a residual income analysis—may be helpful in preserving consumer access to credit while still protecting consumers from becoming caught in unaffordable debt that further worsens their financial problems. The Bureau also believes that the alternative requirements would reduce the compliance costs for lenders.").

[137] *See National Credit Union Administration*, 16 NO. 10 CONSUMER FIN. SERVICES L. REP. 15 (2012).

[138] *Id.* at 26–27.

[139] *Id.*

adding some additional requirements that would include verification of credit history, that the consumer has no other covered loans outstanding, that the making of the loan would not result in the borrower having incurred two such loans within a single six-month period, and providing for a minimum loan term of 45-days.[140] Whether these requirements that go above and beyond those provided in the Payday Alternative Loan program will ultimately be enacted is subject to comments by industry groups and advocates. In any event, any such safe harbor would entail a prohibition against a lender who also serves as the depositary institution for one of the borrower's accounts from being able to sweep the account, exercise a right of setoff, or close the account in the event of a default.[141]

Yet another safe harbor being considered, aside from the NCUA approach, involves loans where the periodic payment-to-income ratio is less than five percent.[142] First, the following screening requirements must be met:

(1) the lender verified the borrower's income;

(2) the lender verifies the borrower's credit history using an approved database as articulated above;

(3) the borrower does not have an outstanding balance on any covered loans nor has the borrower defaulted on a covered loan within the past 12-month period; and

(4) the issuance of the loan would not result in the borrower incurring debt on two such safe harbor loans within a single 12-month period.[143]

Secondly, once these screening requirements are met, the following structural design features would also have to be satisfied:

(1) the periodic payments made to the lender under the loan must be limited to no more than five percent of the borrower's gross income for that specific period;

(2) the loan is subject to a fixed, determinate term of at least 45-days (but no more than six months);

(3) the loan must be repayable in full over at least two relatively equal payments; and

140 *Id.*

141 *Id.*

142 *Id.* at 27–28.

143 *Id.*

(4) there cannot be any prepayment penalties.[144]

New Rules for Consumer Debt Collection

As noted above, the CFPB's proposal deals not only with substantive underwriting requirements (with procedural presumptions) for covered short term loans and covered longer term loans, but it also entails two larger administrative sets of rules.[145] The topic that the CFPB wishes to address deals with the way lenders seek to collect on covered loans by accessing a borrower's deposit accounts.[146] Direct access to a consumer's accounts is one of the ways in which a long term loan can become "covered" by the new rules set forth above.[147] The theory behind the CFPB's concern with such access has to do with the risk that it can create for the borrower in terms of depleting her income as fees, penalties, and interest stacks up on covered terms once a default occurs.[148] The proposed rules call for new notice requirements and limitations on how, when, and how often the lender can attempt to collect.

Notice Requirements

First, the lender would have to send the borrower written notice prior to collecting payment on any covered account through one of the avenues of direct access that the lender may have to the borrower's checking account.[149] By providing such notice, the CFPB hopes to give time for the borrower to better prepare for the sudden reduction in funds.[150]

The notice required by this new rule would need to be given at least three days in advance of the lender's act of direct collection (but no more than seven days prior to the payment being due) and should describe precisely what the act will entail.[151] Such precise information should include

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[144] *Id.*

[145] *Id.* at 28–30.

[146] *Id.*

[147] *Id.*

[148] *Id.* at 28 ("The Bureau is concerned about certain practices associated with collecting payment on all covered loans from consumers' checking, savings, and prepaid accounts. Lenders collect payments from a consumer's account through a variety of methods, including ACH entries, post-dated signature checks, RCCs, payments run through the debit networks, and other means of collecting payment from a consumer's account. The Bureau is concerned that certain lender practices associated with these payment collection methods create substantial risk of consumer harm, including substantial fees, and, in some cases, risk of account closure.").

[149] *Id.* at 29–30.

[150] *Id.*

[151] *Id.*

(1) the exact amount of the payment;

(2) the channel through which the payment will be taken;

(3) a break-down of how the payment will be divided (i.e., interest, principal, fees etc.);

(4) the outstanding loan balance after the payment is taken;

(5) the lender's contact information; and

(6) if the direct access comes in the way of a post-dated check or RCC, then the number associated with such instrument.[152]

Thus, if the direct access is in the way of a payroll deduction, the borrower must be apprised that she can expect her paycheck to be reduced, or if the access is in the way of an ACH then she should expect funds in a certain amount to be automatically debited form her checking account.[153] Whether the notice can be transmitted electronically (email, text message, etc.), if it must come in the mail, or if the borrower can choose, in addition to any language requirements in certain non-English speaking markets, is still up for discussion.[154]

Collection Limitations

The second half of the proposal for consumer debt collection deals with the number of times a lender can attempt to collect payment under a covered loan (whether short or longer term) by directly accessing the borrower's deposit account in one of the ways described above (i.e., ACH, debit, post-dated check, etc.).[155] The fear is that numerous failed attempts to directly access the borrower's deposit account and take repayment may result in the borrower incurring substantial NSF or overdraft fees.[156]

The Bureau noted that while many payday lenders who utilize the ACH system already adhere to the Automated Clearing House network's general three consecutive collection attempts limitation, a wider variety of small value lenders do not, and thus more restrictive measures are enacted.[157] As such, the new rule would cover not only ACH attempts at repayment, but would cover any and all methods whereby the lender attempts to collect repayment through direct

[152] *Id.*

[153] *Id.*

[154] *Id.*

[155] *Id.* at 30–31.

[156] *Id.*

[157] *Id.*

access to the borrower's deposit account.[158] After two failed attempts to collect through this direct access method (because, for example, there are insufficient funds in the account), the lender is prohibited from making additional attempts.[159] And, unlike with the ACH rules, this prohibition would be absolute. Rather than being limited to only additional attempts to directly collect on that particular defaulted payment, the lender would be prohibited from any and all additional attempts to directly collect on any future missed payments, unless the borrower thereafter gave an additional independent authorization for direct access.[160]

New General Compliance Rules

Last but not least, the CFPB is considering the ways in which it can ensure compliance with the rules set forth above.[161] Two methods that the Bureau believes might be effective deal with the policies and procedures used by lenders in furtherance of internal compliance, as well as the imposition of certain record-keeping requirements.[162]

Internal Policies, Procedures, and Policing

First, lenders may be required to internally create and police the use of policies and procedures that are designed to ensure compliance with the substantive and the procedural aspects of the proposed rules.[163] For instance, a specific policy would guide a lender's employees on how to go about making the ability-to-repay determination, as well as how to identify when the presumptions apply and whether the safe harbors are available.[164] This would also include the procedure for submitting credit information to an approved credit database or service once a covered loan is made, and tracking payments and the dissemination of collection notices.[165]

Keeping Good Records

Finally, the compliance rules would also require that lenders keep records related to a covered loan for a period of 36-months after the final entry related

[158] *Id.*

[159] *Id.*

[160] *Id.*

[161] *Id.* at 31.

[162] *Id.*

[163] *Id.*

[164] *Id.*

[165] *Id.*

to that loan has been made.[166] These records would, in turn, be used by the CFPB and their investigators to ensure that the lender is in regulatory compliance.[167] The ability-to-repay documentation, payment history, the borrower's total history of obtaining covered loans, documents relative to the utilization of safe harbors, information relative to any direct access to a consumer's deposit accounts, and information in connection with defaults, delinquencies, and any notices thereof—to name a few—are examples of the types of information that should be included in the record.[168]

In connection with this records retention program, the data from these files would be used to create annual reports that would assist in monitoring compliance of any covered loans, such as reborrowing, notice, and safe harbor limitations.[169]

CONCLUSION

Since the CFPB issued the report a number of fringe economy commentators have already begun both lauding[170] the proposal and arguing that it goes too far.[171] Some assert that although these types of financing products can lead to some borrow harm, the countervailing good—i.e., the provision of credit to otherwise underserved borrowers—outweighs these ills.[172] These groups point to a number of studies that promote the positive aspects of the services provided by small-value financing businesses.[173]

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166 *Id.*

167 *Id.*

168 *Id.*

169 *Id.*

170 Sarah Belton, *CFPB's Proposed Payday Lending Rules: A Big Step in the Right Direction*, Public Justice, Mar. 26, 2014, http://www.publicjustice.net/content/cfpb's-proposed-payday-lending-rules-big-step-right-direction ("Reckoning day for payday lenders has finally arrived.").

171 *See* Jeremy Rosenblum, *Some Issues for "Short-Term" Loans Under the CFPB's Contemplated Payday/Title/High-Cost Lending Proposals*, CFPB Monitor, April 2, 2015, http://www.cfpbmonitor.com/2015/04/02/some-issues-for-short-term-loans-under-the-cfpbs-contemplated-paydaytitlehigh-cost-lending-proposals/; Jeremy Rosenblum, *Some Issues for "Longer-Term" Loans Under the CFPB's Contemplated Payday/Title/High-Cost Lending Proposals*, CFPB Monitor, April 3, 2015, http://www.cfpbmonitor.com/2015/04/03/some-issues-for-longer-term-loans-under-the-cfpbs-contemplated-paydaytitlehigh-cost-lending-proposals/.

172 *See* Jeremy Rosenblum, *The CFPB's Contemplated Payday/Title/High-Cost Lending Proposals: Our Initial Reactions*, CFPB Monitor, April 1, 2015, http://www.cfpbmonitor.com/2015/04/01/the-cfpbs-contemplated-paydaytitlehigh-cost-lending-proposals-our-initial-reactions/ [hereinafter "Rosenblum, *Initial Reaction*"].

173 J. Howard Beales, III & Anand M. Goel, Small-Dollar Installment Loans: An Empirical

Further, many industry watchers have argued that the broad scope of these regulations are not surprising in the least.[174] Rather, it has been very clear for quite some time that these regulations have been coming and that they would be sweeping.[175] According to one prominent banking attorney, the CFPB has shown a pattern when it is preparing to regulate an industry.[176] First, the agency will open up a portal for consumer complaints in that particular area, which is then followed by the collection of data and research about those complaints.[177] This data is then eventually used as a basis for multiple studies and reports on why the industry must be regulated.[178] Once this process has continued for a certain period of time, the regulatory crackdown occurs.[179]

Opponents of these proposed regulations have already hinted at a challenge under the Administrative Procedures Act based on the fact that the regulations are overly burdensome compared to the countervailing service that they provide.[180] However, the fact that the CFPB has been so meticulous in gathering data and compiling their own studies and reports on the negative impacts of the fringe economy evidences that the Bureau is also gearing up for a fight.[181] Who the victor will ultimately be is unclear; however, what is clear is that fringe economy watchers will have much to talk about in the months and year to come.

Analysis, Navigant Economics (Mar. 20, 2015); Ronald J. Mann, *Do Defaults on Payday Loans Matter?*, Columbia Law and Economics Working Paper No. 509 (Dec. 1, 2014); Jennifer Priestley, *Payday Loan Rollovers and Consumer Welfare*, Kennesaw State University Working Paper Series (Dec. 5, 2014) http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534628.

[174] Rachel Witkowski, *CFPB Action Against Payday Lenders 'Building to a Crescendo'*, THE AMERICAN BANKER, Nov. 27, 2013, http://www.americanbanker.com/issues/178_229/cfpb-action-against-payday-lenders-building-to-a-crescendo-1063961-1.html.

[175] *See id.*

[176] *Id.*

[177] *See id.*

[178] *Id.*

[179] *Id.* ("The CFPB often takes complaints first and then uses them to craft rules.").

[180] *See* Rosenblum, *Initial Reaction*, *supra* note 173.

[181] *See, e.g.*, CFPB Data Point: Payday Lending: CFPB Office of Research (March 2014), http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf; *see also* Susanna Montezemolo & Sarah Wolff, Payday Mayday: Visible and Invisible Payday Lending Defaults, The Center for Responsible Lending (March 2015), http://www.responsiblelending.org/payday-lending/research-analysis/finalpaydaymayday_defaults.pdf.