Why Banks Should Pay Attention to the Payday Rule

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Last week, the Consumer Financial Protection Bureau proposed regulations that, if implemented, will reshape the small-dollar lending environment. At the same time, bankers and purchase-money lenders exhaled a collective sigh of relief that the Bureau had focused on someone else's market. But for many in the finance world, including commercial banks, attention to the Payday Rule may pay off. Both public and private payday lenders rely on almost $38 billion annually in commercial credit facilities; payday lenders transact with about 19 million households; and as the small-dollar lending model moves from balloon loans to installment loans, many banks and credit unions that offer Payday Alternative or Deposit Advance products will face increased competition if the rule takes effect. In a nutshell, the proposed Payday Rule (titled, Payday, Vehicle Title, and Certain High-Cost Installment Loans, 12 CFR Part 1041) requires small-dollar lenders to underwrite loans for a consumer's Ability to Repay (ATR) the loan and to retain documents that show ATR. If the paperwork burden seems too high, lenders may opt for one of several alternative structures that contain principle, term, cost limits, and a portfolio default rate of no more than 5%. Both sides of the debate—consumer advocates and payday lenders—object to the rule. But for commercial lenders, investors, payment processors, and asset recovery firms, the Payday Rule presents opportunity. **Subjective lending will cease and documentation will increase** The industry seems to agree that the Payday Rule will decrease small-dollar loan volume, but demand for these loans will not disappear. Currently, payday store managers make most underwriting decisions based on broad company guidelines that often rely on subjective assessments by store staff. Some auto title lenders don't even ask about income – t hey underwrite based on the collateral value of the auto. Under the Payday Rules, to continue underwriting loans with high APRs (i.e. >36%), lenders must rely on consumers' documented ability to repay the loan, which will cause small-dollar lenders to create more robust files about their customers. Asset purchasers and companies that offer credit facilities to small-dollar lenders should benefit from examining this ATR data during due diligence. The data must contain information about consumers' debt and income. The Rule does not require FICO-style information, but it does require using a national data system to ensure the consumer isn't taking out multiple loans within the same six-month period. This database should also help locate consumers if loans go to collections. Even if the Payday Rule causes a 25% decrease in volume, the industry will continue to require roughly $28.5 billion in commercial financing. When it comes to underwriting the commercial credit lines, as well as asset recovery, the Payday Rule's documentation requirements should make predictions more accurate, which ultimately makes financiers and debt-recovery firms more profitable. **The Payday Rule will push the small-dollar market toward issuing longer-term installment loans** Loans that retain high APRs must take into account consumers' ability to repay the loan. The present problem is that payday lenders offer consumers too much money, at too high a cost, and in too short of a time to pay off the loan. The CFPB cannot legally set interest rates, so it must dictate other cost elements of a loan: principle amount, amortization, and term. Most consumers can't afford to repay these loans in a month, and repeated rollovers are banned under the Payday Rule, so the profitable alternative for lenders is to extend the payment term over several months. Current offerings in the small-dollar market often allow up to one year to repay the loan. Lenders that wish to avoid ATR underwriting may offer loans that resemble the current credit union Payday Alternative Loan (PAL), which caps principle amounts to $500 and the APR to 28%. For non-payday firms that invest in this space, the credit union PAL experience provides robust comparisons to aid in predicting performance. **The Payday Rule offers a clue about overdraft and Regulation E** The Payday Rule sets a two withdrawal-attempt limit on electronic/ACH withdrawals. Most online payday lenders collect payments via electronic debit. Borrowers authorize payment withdrawals when taking out the loan. The Payday Rule's two withdrawal-attempt limit is meant to address online lenders' peculiar practice of seeking to collect multiple payments in the same day and/or dividing amounts due into two or more presentments on the theory that half is better than none. The multiple attempts can cause high non-sufficient fund fees (NSF fees) on the account. The Bureau's ban on three or more withdrawal attempts is an important clue for depository institutions as to how the agency might approach Electronic Fund Transactions in the future. In 2015, banks with over $1 billion in assets reported overdraft and NSF fee revenue of $11.16 billion. As these banks know, the Bureau has had overdraft fees in its sights for years. It's telling that in the Payday Rule the agency approached overdrafts with a numerical limit. In addition, the proposed Rule also requires enhanced notices to consumers that exceed what EFTA/Regulation E presently requires. Whether these approaches go into the final rule and survive judicial review will presage future rulemakings regarding overdraft and Regulation E. Regardless of your institution's current exposure to the Payday Rule, the changes coming to this industry because of CFPB intervention present potential opportunities and important insights. The attorneys and analysts at Carlton Fields will do our best to keep you informed.

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