MEMBERS
ANDY VIDAK
VICE CHAIR
CATHLEEN GALGIANI
ISADORE HALL, III
BEN HUESO
RICARDO LARA
MIKE MORRELL

California State Senate

SENATE COMMITTEE
ON
BANKING AND FINANCIAL INSTITUTIONS

STATE CAPITOL
ROOM 405
SACRAMENTO, CA 95814

TEL (916) 651-4102
FAX (916) 266-9382

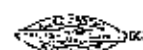
STAFF DIRECTOR
EILEEN NEWHALL

COMMITTEE ASSISTANT
RAE FLORES

SENATOR MARTY BLOCK
CHAIR

ENDING DEBT TRAPS OR RESTRICTING ACCESS TO SAFETY NETS? INITIAL REACTIONS TO THE CONSUMER FINANCIAL PROTECTION BUREAU'S LENDING PROPOSAL

BACKGROUND PAPER



INTRODUCTION

On March 26th, 2015, the federal Consumer Financial Protection Bureau (CFPB; the Bureau) released an outline of proposals it is considering adopting to provide greater protections for consumers who take out payday loans, high interest rate installment loans, and car title loans (http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf). Although the proposals are preliminary, they will form the basis for the CFPB's rulemaking in this area. Furthermore, once the CFPB finalizes its consumer lending regulations, the new rules will apply in all fifty states; they will not require legislative or congressional approval to become effective. In California, the new rules will affect over 12 million payday loans, totaling over $3.1 billion annually, and over 500,000 installment loans, totaling approximately $1 billion annually.

Because the CFPB's rulemaking will have such a significant impact in California, it is critical that the California Legislature begin reviewing the proposals now, before the CFPB becomes locked into any particular regulatory approach. On May 6th, the California Senate Banking and Financial Institutions Committee will convene an oversight hearing to solicit feedback on the CFPB proposals outlined in the CFPB's March 26th release. The hearing is designed to help Committee members, interested members of the public, and the CFPB understand the potential impacts of the CFPB proposals on California consumers, California businesses, and the California economy as a whole. The Committee will hear from the California Research Bureau, Commissioner of the California Department of Business Oversight, and nearly twenty other witnesses, representing a variety of viewpoints. Witnesses include consumer advocates; attorneys who represent consumers in predatory lending actions; small and large lenders, including one tribal lender; lenders that lend exclusively online; lenders that operate exclusively through brick-and-mortar storefronts; payday lenders; unsecured installment loan lenders, and car title lenders.

Following the hearing, staff will prepare a final report that summarizes oral witness testimony and compiles written testimony submitted to the Committee in connection with the hearing. A copy of that final report will be posted on the Committee's web site, along with this background paper and an archived video recording of the hearing.

The remainder of this background paper summarizes the CFPB proposals and describes the process that CFPB will undertake to develop its final rule. It also discusses the choices with which the California Legislature will be faced following adoption of that final rule.

SUMMARY OF PROPOSAL

Short-Term Credit Products Covered By the Proposal:

- The CFPB's short-term covered loan proposal covers loans with a contractual loan term of 45 days or less. According to the CFPB, this proposal covers payday loans, deposit advance products, open-end lines of credit where the credit line terminates within 45 days or the credit is repayable in full within 45 days, and short-term vehicle title loans. In California, the most significant impact of the short-term loan proposal will be felt by

payday lenders (i.e., those licensed under the California Deferred Deposit Transaction Law; CDDTL; payday loan law). The short-term covered loan proposal also has the potential to impact California depository institutions that offer deposit advance products (payday loan-like products offered by depository institutions). However, because no depository institutions in California are currently offering deposit advance products, this impact is more theoretical than real; in practice in California, the short-term loan proposal will be felt almost exclusively by payday lenders and their customers.

Longer-Term Credit Products Covered By the Proposal:

- The CFPB's longer-term covered loan proposal covers loans with a contractual loan term of greater than 45 days, where the "all-in" annual percentage rate (APR) exceeds 36%, and lender collects payments through access to a consumer's deposit account or paycheck or holds a security interest in the consumer's vehicle.

  The "all-in" APR includes all interest and fees associated with the loan, *plus* the cost of any add-on products sold along with the loan, such as credit insurance memberships. "Access to a consumer's deposit account or paycheck" includes a post-dated check; automated clearing house (ACH) authorization; remotely created check (RCC) authorization; authorization to debit a prepaid card account; payroll deduction; a right of setoff or to sweep funds from a consumer's account; and any other method of collecting payment from a consumer's checking, savings, or prepaid account.

  According to the CFPB, the longer-term covered loan definition includes vehicle title loans with a contractual loan term greater than 45 days, as well as certain unsecured installment loans and open-end loans. In California, the longer-term covered loan proposal will have its greatest impact on lenders licensed under the California Finance Lenders Law (CFLL; installment loan law), which extend car title loans and installment loans with annual percentage rates greater than 36%.

Lenders Are Given a Choice Of How to Comply:

Both proposals allow lenders to choose their method of compliance. The CFPB characterizes option one under both proposals as "debt trap prevention," and option two under both proposals "debt trap protection."

Need For a Centralized Database or Other Loan Tracking System: Both of the CFPB's proposals require lenders to verify a borrower's borrowing history and report a borrower's use of a covered loan. To fulfill these requirements, the CFPB expects lenders to rely on what the Bureau calls a "commercially available loan reporting system." While some read that language as requiring a centralized loan database, the CFPB suggests that compliance may be achieved through alternate means.

In language accompanying the proposals, the CFPB explains that "the Bureau anticipates that it would specify criteria that would make a consumer reporting system eligible for lenders to use in verifying borrowing history. To facilitate consideration of borrowing history, lenders would be

required to report use of covered loans to commercially available reporting systems meeting the Bureau's eligibility criteria. Under this proposal, lenders would need to report to all applicable commercially available reporting systems, but would have to check only one such reporting system meeting the Bureau's eligibility criteria.

"The Bureau understands that in the payday lending market, may states currently require lenders to check a state-recognized database prior to the extension of certain loans and to report consumer use of those loans to the same database. The Bureau also understands that, as part of their own risk analytics when making loans, many lenders voluntarily use a handful of credit reporting agencies that provide information about a consumer's loan history. The Bureau is not considering creating its own reporting system for borrowing on covered loans. The Bureau also is not considering administering or otherwise contracting with a third-party to create or administer a reporting system."

Details of the Proposals: As envisioned by the CFPB, a lender making a covered loan (either short-term or longer-term) will have to comply with *either* the debt trap prevention requirements (Row 2 in the table immediately below) *or* the debt trap protection requirements (Row 3 in the table below). That lender will also have to comply with *both* the borrower notification requirements (Row 4) and the cap on unsuccessful attempts to debit an account (Row 5).

	Short-Term Covered Loans	**Longer-Term Covered Loans**
Debt Trap Prevention	Determine ability to repay before extending credit: A lender must verify a borrower's income, major financial obligations, and borrowing history, and make a good faith, reasonable determination that the borrower has enough money to repay the loan after satisfying major financial obligations and living expenses. A lender may not extend a new short-term covered loan to a borrower who already has an outstanding short-term covered loan from any lender. A commercially available loan reporting system that tracks short-term loans across all lenders making these types of loans will be necessary to comply with this requirement. Minimum 60-day cooling off	Determine ability to repay before extending credit: A lender must verify a borrower's income, major financial obligations, and borrowing history, and make a good faith, reasonable determination that the borrower has the ability to repay the loan (including principal, interest, and fees for add-on products) after satisfying major financial obligations and living expenses. If the lender is extending a covered longer-term loan with a balloon payment, underwriting must consider income and major financial obligations for 60 days beyond the term of the loan. A lender may not extend a new loan or refinance an existing loan without new underwriting. If a borrower has been delinquent, a lender is prohibited from

	Short-Term Covered Loans	Longer-Term Covered Loans
	period between loans (with an exception): A lender must wait at least 60 days after a borrower pays off their prior short-term covered loan before extending a new short-term covered loan to that borrower, *unless* the lender can document that the borrower's financial circumstances have improved enough to repay a new loan without re-borrowing. Minimum 60-day cooling off period between loans (no exception): After three successive loan with less than 60 days between them, a lender may not make a new short-term loan to the same borrower for at least 60 days.	refinancing that borrower into another loan with similar terms, without documentation that the borrower's financial situation has improved enough to allow that borrower to afford the new loan. 60-day cooling off period following a longer-term loan with a balloon payment: A lender must wait 60 days before extending credit to a prior borrower, unless the lender can document that the borrower's financial circumstances have improved enough to repay the new loan without re-borrowing. After three loans in a row with less than 60 days in between them, a lender may not make a new loan to the same borrower for 60 days.
Debt Trap Protection	Available only for the following loans: loan amount must be $500 or less, loan term must be 45 days or less, no more than one finance charge may be imposed, and a borrower's vehicle may not be used as collateral. Lenders making short-term covered loans that do not meet these criteria must comply with the debt trap prevention requirements above. Limitations on repeat borrowing: If all the criteria above are met, a lender will have to verify a borrower's income and borrowing history; and, before extending a new loan to that borrower, ensure that the borrower does not already have a covered loan outstanding with any lender; ensure that the new loan will not result in the borrower having taken out more than three short-term covered	This option is available only for loans with durations between 45 days and six months. Lenders making longer-term covered loans with durations greater than six months must comply with the debt trap prevention requirements above. For loans that do meet the eligibility criteria for the debt trap protection option, two alternatives are available. Under the first (so-called NCUA-type) alternative, the loan principal must be between $200 and $1,000, the application fee is capped at $20, the interest rate is capped at 28%, the loan must be fully amortizing over at least two payments, the lender must verify a borrower's income and 9borrowing history, must report

	Short-Term Covered Loans	Longer-Term Covered Loans
	loans in sequence, with less than 60 days between loans; ensure that the new loan will not result in a borrower receiving more than six covered short-term loans from any lender in a rolling 12-month period; and ensure that, following completion of the contractual loan term, the borrower will not have been in debt on covered short-term loans for more than 90 days in the aggregate during a rolling 12-month period. In addition to those requirements, a lender that wants to extend a short-term covered loan to a borrower who previously obtained a short-term covered loan within the prior 60 days will have to choose between two different options aimed at offering borrowers an affordable way out of their short-term debt. Under the first option, the lender will have to reduce the principal amount of each subsequent loan over the course of a three-loan sequence (e.g., $300, $200, $100). Under the second option, the lender will have to provide a borrower unable to repay his or her third loan according to its terms with a no-cost loan extension, which allows the borrower four additional installments in which to repay the loan, without incurring additional cost. If this option is selected, the lender may not extend any additional credit to the borrower for at least 60 days following repayment of the third loan.	use of the loan to all applicable commercially available reporting systems, and, before extending a new loan, must verify that the borrower does not have any other outstanding covered loans, and ensure that the new loan will not result in a borrower having more than two of these types of loans in a rolling six- month period. Under the second alternative, the lender must verify the borrower's income and borrowing history, report use of the loan to all applicable commercially available reporting systems, and, before extending a new loan, ensure that loan payments will not exceed 5% of the borrower's gross monthly income, verify that the borrower does not have any other outstanding covered loans, and ensure that the new loan will not result in a borrower having more than two of these types of loans in a rolling twelve- month period.

	Short-Term Covered Loans	Longer-Term Covered Loans
Borrower Notification Before Accessing Deposit Accounts	A lender must provide each of its borrowers with three business days' advance notice before submitting a transaction to the borrower's bank, credit union, or prepaid account for payment.	A lender must provide each of its borrowers with three business days' advance notice before submitting a transaction to the borrower's bank, credit union, or prepaid account for payment.
Limit Unsuccessful Withdrawal Attempts	A lender may not make any more than two unsuccessful attempts to collect money from a borrower's account. Before a lender may attempt to collect money from that account a third time, the borrower would have to provide new authorization to that lender.	A lender may not make any more than two unsuccessful attempts to collect money from a borrower's account. Before a lender may attempt to collect money from that account a third time, the borrower would have to provide new authorization to that lender.

COMPARISON OF CALIFORNIA LAW AND THE PROPOSALS

CDDTL (Payday Loan Law): The short-term covered loan proposal will have its greatest impact in California under our payday loan law. Generally speaking, and as discussed below, none of the requirements of the short-term covered loan proposal are already present in California law.

- The debt trap prevention option requires underwriting to determine a borrower's ability to repay (not required under California's payday loan law), prohibits the extension of a short-term covered loan to any borrower with an outstanding, short-term covered loan from any lender (California's law prohibits the same lender from extending more than one payday loan to a borrower with a payday loan outstanding, but California's regulator does not apply this prohibition across multiple lenders, as is contemplated by the CFPB), and limits the frequency with which short-term loans can be extended to borrowers that obtained a prior short-term loan during the recent past (California's law lacks any restrictions around lending frequency).

- The debt trap protection option is available only for loans that are less than $500, shorter than 45 days, and include only one finance charge. These criteria are consistent with California's payday loan law, which caps the maximum face value of a check that may be presented by a borrower at $300, caps the maximum length of a loan at 30 days, and allows only one finance charge, equal to $15 per $100 borrowed. Thus, California licensed payday lenders would be eligible to use the debt trap protection option, if they wish.

  Any lender wishing to use the debt trap protection option for its short-term covered loan will need to verify a borrower's income and borrowing history (not required under California law), ensure that a borrower seeking a short-term covered loan does not have another short-term loan outstanding from any lender (California's law prohibits the same lender from extending more than one payday loan to a borrower with a payday loan

outstanding, but California's regulator does not apply this prohibition across multiple lenders, as is contemplated by the CFPB proposal), limit the frequency of repeat loans by the same borrower (California law lacks any restrictions around lending frequency), and following three consecutive loans, offer borrowers an affordable way out of debt (California law lacks special rules for borrowers who have taken out consecutive loans).

- The borrower notification requirements and cap on successive unsuccessful attempts to debit an account also represent new requirements, relative to existing California law. California's payday loan law does not require lenders to notify borrowers before debiting the borrowers' accounts, nor does it limit the number of repeated, unsuccessful attempts to debit an account.

CFLL (Installment Loan Law): The longer-term covered loan proposal will have its greatest impact in California under our Finance Lenders Law.

- The CFPB longer-term loan proposal will have little impact on installment loans made in California in amounts below $2,500. With one exception (the Pilot Program for Increased Access to Responsible Small-Dollar Loans; pilot program), the CFLL caps interest rates and fees on installment loans with principal amounts below $2,500 at levels below 36% APR. The longer-term covered loan proposal applies to installment loans greater than 45 days in length, whose "all-in" APR exceeds 36%. Thus, the CFPB proposal is unlikely to impact the general provisions of the CFLL that apply to loan amounts below $2,500.

- The pilot program does allow for interest rates and fees that can result in an all-in APR in excess of 36%. Depending upon the amount borrowed and the loan length, some pilot program loans do exceed 36% APR; others are below this threshold. Some pilot program lenders do not access their customer's deposit accounts; others do, and could therefore be covered by the CFPB proposal. However, because the pilot program requires rigorous underwriting to evaluate borrowers' ability to repay their loans and limits the frequency with which pilot program loans may be refinanced, it appears that compliance with pilot program rules will automatically place a pilot program lender into compliance with the debt trap prevention rules for longer-term loans.

  The only areas where changes to the pilot program rules may be necessary to conform to the CFPB proposal lie in the areas of borrower notification prior to a collection attempt and limitation on the number of successive collection attempts made. The pilot program requires that borrowers be given a reminder about their next payment two days prior to that payment (rather than three, as proposed by CFPB). Furthermore, the pilot program does not cap the number of times a lender may attempt to debit a borrower's account to collect a payment, if the first attempt is unsuccessful.

- In contrast, the CFPB's longer-term covered loan proposal will have a significant impact on installment loans made in California in amounts of $2,500 or more, because none of the requirements of that proposal are contained in California law. For example, the CFLL does not cap interest rates on installment loans with principal amounts of $2,500 or

more, require these loans to be rigorously underwritten, limit the frequency with which these loans can be made or refinanced, require lenders to notify borrowers before accessing their accounts, or limit the number of unsuccessful attempts to debit a borrower's account.

Although Section 1452 of Title 10 of the California Code of Regulations references the need for finance lenders to take into consideration the ability of borrowers to repay their loans according to their terms, that regulation is quite vague; it requires finance lenders to "take into consideration, in determining the size and duration thereof, the financial ability of the borrowers to repay the same, to the end that the borrowers should be reasonably to repay said loans in the time and manner provided in the loan contracts."

NEXT STEPS

The document released by the CFPB on March 26th is an outline of a proposal; it is not a proposed regulation. Before the CFPB can issue its proposed regulation, it must solicit input from small business representatives regarding the potential impact of its rule on small businesses. The Small Business Regulatory Enforcement Fairness Act (SBREFA) requires the CFPB to convene a Small Business Review Panel when it is considering a proposed rule that could have a significant economic impact on a substantial number of small entities. The Dodd-Frank Wall Street Reform and Consumer Protection Act further requires the CFPB to collect advice and recommendations from small businesses and non-profits on whether any of its proposals are likely to increase the cost of credit for small business lenders and to solicit idea for alternative approaches that would minimize any such increases. The proposals released by the CFPB on March 26th were intended to provide necessary background to facilitate the Small Business Review Panel process.

The SBREFA Small Business Review Panel held a meeting on Wednesday, April 29th, 2015 to discuss the CFPB's March 26th outline. Within 60 days following that meeting, the Panel is required to complete a report for submission to the CFPB. The Bureau is required to consider the Panel's report as it prepares its proposed regulations.

The CFPB will also be considering feedback from several other entities when developing its proposed regulations. In its March 26th release, the CFPB indicated that it is "also consulting with other federal agencies, as well as tribal governments, and is seeking feedback from a wide range of other stakeholders on the proposals under consideration." Witness testimony provided during this Committee's May 6th hearing will offer the CFPB some of the feedback it is seeking.

Once published in the Federal Register, likely sometime later this year, the CFPB's proposed regulations will be subject to a formal public comment process. Final regulations will follow, once public input on the proposed regulations has been considered. When it issues its final regulations, the CFPB expects to provide businesses covered by the regulations with some period of time in which to implement the new rules, before they will be enforced. Given this timeline, the issuance of proposed regulations is likely sometime during 2015, and issuance of final regulations is likely to follow during 2016.

THE ROLE OF THE CALIFORNIA LEGISLATURE

Members of the California Legislature may provide comments to the CFPB at multiple stages in the CFPB's rulemaking process. However, once the CFPB finalizes its regulations, those rules will apply in all fifty states. Where existing state law is more protective of consumers than the CFPB regulations, state law will govern. Where the CFPB regulations are more protective of consumers than state law, the CFPB regulations will govern.

Once the CFPB regulations are finalized, the Legislature will have to decide whether to update the Deferred Deposit Transactions Law and Finance Lenders Law. Doing so will likely minimize confusion about what protections are available to California borrowers and what rules apply to California licensed lenders. Updating California law will also clarify the authority of the Commissioner of the Department of Business Oversight to enforce the new rules in California.

However, revising and updating the Deferred Deposit Transaction Law and Finance Lenders Law is likely to spark fierce debate over the extent of the revisions. Some will likely argue for simple conformity with the federal regulations. Others are likely to argue that California should go beyond the federal regulations, and ensure that our laws are more protective of consumers than what is required by the CFPB. These debates are likely to begin later this year and continue through 2016, perhaps beyond.