The CFPB Is At It Again*

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The Bureau of Consumer Financial Protection (CFPB) recently announced its proposed rules to increase regulation of payday loans, vehicle title loans, and certain other loans in order to prevent customer abuse. Weighing in at over 1300 pages, the proposal dwarfs the Volcker implementing rule in size, an initiative that involved five federal agencies and, at the time, elicited industry howls for excessive burden. We can expect a similar reaction for this initiative as well. The idea of preventing customer abuse is laudable but the reader should also consider the dangers of a potentially paternalistic approach that could be extended on a far wider scale, to the detriment of the rights of states to regulate commerce within their boundaries.

The proposal covers what the reader will recognize as payday loans loans with a term of 45 days or less and some longer term loans with a percentage rate higher than 36 percent. Also targeted are loans that are repaid directly from the customer's bank account or are secured by a vehicle. The CFPB bases its proposal on extensive outreach efforts with lenders, consumer groups, trade groups, and four years of study of the lending industry for those products and state laws that regulate such lenders. According to the CFPB, the target is lightly regulated private concerns rather than more highly regulated banks and credit unions. The CFPB justifies its proposal on a body of evidence including its own enforcement actions and investigations and complaints of abusive practices. That view, however, can be interpreted as sometimes condescending and often illogical.

The CFPB is addressing such loans in its proposal because those loans "are typically used by consumers who are living paycheck to paycheck, [and who] have little to no access to other credit products." It is not clear why those same pressures on middle income borrowers are any less severe and why similar cures would be any less necessary as a policy matter for those borrowers who similarly become overextended and rack up high credit card balances, for example. Even so, the CFPB would exclude several other types of consumer credit from the scope of the proposal,

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including home mortgages, credit cards, student loans, and overdraft services, all of which have been the subject of numerous consumer complaints.

There is a degree of illogic when the proposal would identify as an abusive and unfair practice the making of a loan when the lender has not determined that the consumer has the ability to repay. A bank regulator would rather call the making of such a loan unsafe and unsound, and not particularly abusive, because the borrower in such an event might not repay the loan and it is the bank that would suffer from the loss. In this case, the lender is making a loan with its own funds, not insured deposits. It is therefore less likely that a lender would purposely lend in an obviously losing proposition. Yes, there is always the risk in lending that some borrowers will not repay, and fees and interest will help compensate for such losses. That, however, does not lead inexorably to the conclusion that the lender seeks to make a losing loan.

The CFPB seems to intuit that too wide a range of charge-offs across the lending spectrum is prima facie evidence of customer abuse. It cited one example of a firm that experienced gross charge-offs of 30 % on the firm's vehicle title loan portfolio as apparent evidence of a business model that does not depend on loan repayment. There is not such a wide difference between that charge-off rate and the rate often predicted for credit card portfolios, which can run north of 25%.

The fact is that charge-off rates can vary widely among loan products, geographic regions, and the type of market participant acting as lender. It is not clear that eliminating or restricting players with higher charge-off rates will result in fairer or less abusive lending; instead it is more likely that other lenders will spring up where others wither under a new regulatory burden as the CFPB has not done anything to reduce the demand for such products. The CFPB itself recognized that even though federal and state regulators have undertaken a number of initiatives over the last 15 years to minimize the negative attributes of payday lending, the industry has tended to shift to new models and products in response.

The CFPB seems to be assuming the role of bank regulator in an industry that appears to be offering an alternative to banks. It also seeks to be the central arbiter of that regulation, after apparent frustration with varying approaches among the states to regulating payday lending. For example, the CFPB obviously disapproves of the fact that underwriting policies and practices that vehicle title lenders use can vary and may depend on such factors as state law requirements and individual lender practices. It will fix that problem.

The CFPB has now substituted its judgment for that of the lender (and the states) by creating a detailed framework of how a lender may underwrite a covered loan. The lender must verify the borrower's (1) net income; (2) debt obligations using a national consumer report and a consumer report from a "registered information system;" and (3) housing costs. The lender also must forecast the borrower's basic living expenses and project net income, debt obligations, and housing costs over the term of the loan. A lender would be required to establish and follow a compliance program and retain certain records. A lender also would be required to develop and follow written policies and procedures to ensure compliance with the proposal.

In essence, the CFPB wants to fiddle with supply and demand and shape the provision of credit to the low- and moderate-income market, ignoring the desires and rational choices of credit suppliers

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and consumers. The CFPB would prohibit a lender from making several loans in sequence to the same borrower over a specified time period, but the prohibition likely would be futile. The CFPB, in the same proposal, reported that the average number of payday loan stores in a county with a payday loan store is 6.32. In states that record such data, half of all such stores are less than one-third of a mile from another lender. Even if one payday lender cuts off credit as required, that borrower surely can find another fix nearby.

Perhaps this is the reason underlying an ambitious aspect of the proposal to "require lenders to furnish to registered information systems basic information for most covered loans at origination, any updates to that information over the life of the loan, and certain information when the loan ceases to be outstanding." The next question is why would such a system be necessary, other than to facilitate enforcement? The proposal identifies a need for "a reasonably comprehensive record of a consumer's recent and current borrowing," but isn't that what the credit reporting agencies currently do? Why wouldn't the CFPB later extend such "protection" to higher income borrowers? Where does the process end?

In another example of paternalism, the CFPB objects to and would restrict payday lenders seeking to withdraw loan payments from borrowers' bank accounts. Payday lenders, like bank lenders, often will make repeated attempts to withdraw funds from borrower accounts. While the success rate on such attempts may be relatively low, and the cost to consumers may be correspondingly high, that is the most obvious option that any lender seeking repayment can follow.

The CFPB objects to the level of fees borrowers may have to pay their banks if there are insufficient funds to cover the withdrawals an unrelated lender may make. Rather than directly regulate bank fees, however, the CFPB would act indirectly and restrict the payday lender.

The CFPB does not trust the judgment of the consumers it would protect in the proposal. Rather than require payday lenders to make certain additional disclosures to customers, the CFPB finds that unspecified "behavioral factors" make it likely that such disclosures would be ineffective in warning consumers of the risks and preventing the harms that these loans involve. Apparently, the borrowers will take out the loans anyway, presumably because they want or need the loans. Therefore, the CFPB seems to think it can simply choke off the supply.

The CFPB finds it unacceptable that borrowers face three choices when they can't make a loan payment in any month: take out another loan, default, or make the payment and fail to meet other payments or expenses. Yet, that is the choice facing any borrower with insufficient funds to cover expenses and the choice can be painful. That does not, however, justify placing a lender at the back of the line of other creditors and in effect reward borrowers who make spending or budgeting errors.

One must ask at this point, what is the provision of law that gives the CFPB the authority to propose such a regulatory scheme and take away the authority of the states to regulate commerce and credit within their borders? The CFPB would adopt these regulations primarily pursuant to authority under section 1031 of the Dodd-Frank Act to identify and prevent unfair, deceptive, and abusive acts and practices. The CFPB argues that it is "reasonable to interpret Dodd-Frank Act section 1031(b) to permit the imposition of requirements to prevent acts or practices that are

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identified by the Bureau as unfair or deceptive so long as the preventive requirements being imposed by the Bureau have a reasonable relation to the identified acts or practices." Taking that argument to its logical conclusion, there is virtually no segment of the consumer credit markets that could escape the reach of the CFPB. The CFPB is well aware of the effect of its actions as it stated outright that it "believes that Federal intervention in these markets is warranted at this time." In effect, the CFPB is arguing that Title X of Dodd-Frank gives it the authority to preempt state law.

One can predict that if the CFPB does not significantly revise its proposal, a court challenge to a final regulation will result.

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