Lenders Riding a Regulatory Rollercoaster

THOUGHT LEADERSHIP

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Regulatory Rollercoaster for Lending includes Future Federal Governance Uncertainty & Perpetual State Adjustments

Pressure to repeal, modify, or amend Dodd Frank leads the charge for change

When the Dodd-Frank Wall Street Reform and Consumer Protect Act (Dodd-Frank) was passed on July 21, 2010, every U.S. financial organization or other lending entity offering products to consumers were mandated to abide by to new regulatory compliance rules and policies, revised lending practice guidelines, and governance by the Consumer Financial Protection Bureau (CFPB).

The impact of both specific legislation and corresponding CFPB actions have led to enormous angst for lenders required to follow the rapid-fire new compliance rules & regulations. Adding to the complexity are a series of state-specific "adaptations" to lending rules and practices.

CFPB / Federal Regulations

During these times of re-regulation, **nothing created more uncertainty and anxiety throughout the consumer lending industry** as the "evolutionary" provisions under Dodd-Frank. Everything from the lack of oversight in the structure of the CFPB to the vague and rather equivocal nature of many of the directives and regulations promoted by that agency have only heightened the tension and adversarial view of the industry toward the regulators. **This leaves creditors/financial institutions without a clear path to compliance.**

Historically, Federal regulation was primarily concerned with disclosure statutes and regulations aimed at ensuring consumers received accurate information about their credit transaction. That focus changed with the passage of the Talent Amendment in 2007, which introduced the concept of the MAPR (Maximum Annual Percentage Rate) and set a 36% all-in rate cap on covered loans.

Since 2007, both the CFPB and state legislators have striven to implement what has become known in the industry as the "all-in APR."

Dodd Frank Act:

No provision of this title shall be construed as conferring authority on the Bureau to establish a usury limit applicable to an extension of credit offered or made by a covered person to a consumer, unless explicitly authorized by law.

Of all the CFPB regulations proposed in the last 6 years, **the one with the most ominous potential implications** is the so-called **Small Dollar Rule***, which was intended to address and curb payday lending, and to introduce an all-in rate cap of 36%. While the CFPB has no direct statutory authority on rate making, the recent Small Dollar Rule proposal was, in effect, a “back-door” usury rate ceiling effecting a wide range of small loan lenders.

The Small Dollar Rule is predicated primarily on determining the consumer’s “ability to repay” the loan — through a rather cumbersome non-traditional process — in order to invoke two of the CFPB’s flagship rather-ambiguous concepts: “unfair and abusive.”

The post-election status of CFPB Director Richard Cordray has also fueled higher levels of anxiety and uncertainty throughout the industry.

Accelerated & Ongoing State Regulation

To date, States have continued their efforts to adapt to anomalies in their own regulations while concurrently navigating through the impact of Federal statutes.

The adoption of the Talent Amendment and its influence on a central part of the proposed Small Dollar Rule has **filtered down to the state level**, which traditionally has been the playing field for determining “how much can be charged.”

Here are some of the recent state-specific regulatory modifications, updates, and amendments:

- **380 bills have been introduced since 2009 to cap rates at either 36% or less**
- **Since 2013, 32 state bills have been introduced for “all-in APR” legislation**
- **Maryland – unsecured open-end credit capped at 33% all-in**
- **South Dakota – 2017 legislation with all-in cap at 36%**
- **Massachusetts – GAP classified as state finance charge – 21%**
- **Colorado 2017 Admin Opinion – debt other than GAP is state finance charge at UCCC rates**

The proposed CFPB Small Dollar Rule continues to influence state regulation. And the Talent Amendment continues to have a carryover effect, specifically on the definition of an APR. States continue to propose "All-in APR" legislation.

Establishing the Foundation for Computational Compliance

With so many of the CFPB directives and initiatives containing subjective requirements and undefined provisions, **it is difficult for creditors to properly prepare and create a compliance program addressing the wide breadth of all potential requirements**. Whether it's the potential passage of the Small Dollar Rule, the continuing state all-in rate cap proposals, or the future leadership of the CFPB, many compliance components remain unknown.

"Alignment":

- Put simply – the numbers **have to** sync up from the point of taking a credit request through producing loan documents
- Computational alignment throughout the lifecycle of the credit process is essential to assure full lending compliance

But you can proactively remove your calculation and disclosure values from the equation by ensuring there is consistency and compliance throughout the lifecycle of the transaction. No matter what aspect of compliance is being contemplated, the **one common denominator** for all credit transactions, both open and closed end, is that **there are NUMBERS on an agreement**.

Too often those values are taken for granted as "just math" and not given the proper examination and inspection on a regular basis.

Just how does a creditor ensure their numbers are consistent from beginning to end? Through the process of "Alignment."

- The contract/agreement contains provisions of how interest/finance charges will accrue.
- The disclosures on the agreement conform to the accrual language and other pertinent provisions.
- The servicing of the loan during collection accrues charges in accordance with the first two items.

One simplistic way to view alignment is that if all disclosed payments were posted in the servicing system on their schedule due dates, the final outstanding balance at maturity would be "0." **Lenders might just be surprised how often that is not the case**, since their operations do not frequently/regularly validate these key points as a best practice.

As with so many things, the devil is in the details. The three parts of the alignment process are often disparate systems with little, or no, coordination of the granular level details, e.g. parameters and settings, that drive consumer credit mathematical calculations. As just one example, how do the disparate systems implement an interest accrual calendar?

We often hear "we use a 365-day year" or "we use a 360-day year." However, at Carleton we currently recognize 12 potential accrual calendars. It is not simply "A" or "B" as the only options, if the desired end result is to be precise and accurate. Do the origination system and the servicing system use the same interest accrual calendar?

Furthermore, when discussing specifications within lending organizations themselves, there's **one key question that should be asked: Are there ongoing synergy discussions with the servicing arm of the company?** A common response: "No, those guys are over in another building and we don't talk to them unless we have to."

What do you think the chances are that the end results align all the critical corresponding financial elements/components? [*Hint: Not Very Good*!]

Tools Required to Calm the Waters

Particularly if a creditor operates in a **multi-jurisdictional** environment – **all** aspects of the alignment process should be reviewed on a regular basis. Apparent "minor" changes to contractual provisions can have a significant impact on the resulting disclosure values. Correspondingly, the creator or architect of an origination system at its inception may be long gone, retired, deceased or driven mad by the details of consumer credit math. **Does anyone in the organization really know the detailed inner workings of the system**?

One of the planks of the CFPB's published manifesto for a compliance management system is independent third-party audits of all aspects. From beginning to end, all documents, calculations, disclosures, and payment histories should be evaluated for accuracy, compliance, and consistency. Notice that **accuracy and compliance are listed separately**. Compliance with many state statutes is incredibly nuanced, esoteric, and often unclear.

There are several state statutes that contain provisions such as:

"Interest charges shall accrue on the number of actual days elapsed."

However, in the next line, or perhaps in a corresponding rule, the following will be stated:

"A day is 1/365 of a year."

These kinds of regulatory definitions can raise as **many questions** as they attempt to answer.

<u>Here's just one example:</u>

What is the actual impact when the Gregorian calendar adds February 29th every four years?

If a loan includes a leap year within the repayment schedule of a 12.00% base rate – does that mean that when using a daily rate of 1/365th for all years except the leap year and 1/366th for the leap year, the total rate results in an <u>exact</u> 12.00% accruing interest rate?

Not necessarily.

In this case, the nominally-applied 12% rate ***might*** actually turn into a 12.05% effective rate?

The Pathway Ahead

While the **total alignment process** necessitates reviewing contract language, disclosure values, and servicing calculations from a historical perspective, the disclosure calculations themselves can be monitored in real-time fashion with the insertion of software containing a compliance component.

Daily or weekly batch runs—or even individual transactions as they occur—can be evaluated **and provide extra assurance** that a broad portfolio of transactions does not accumulate with calculation compliance issues.

Regardless of what political party occupies Congress or the White House, or the ultimate fate of the CFPB, it is important that a lender's compliance program is truly **comprehensive** – including calculations throughout **all phases** of the lifecycle of the credit transaction.

The world of consumer credit mathematics is incredibly esoteric. The 50-state landscape represents a diverse kaleidoscope of requirements, provisions, and local interpretations of concepts and language. Having successfully passed examinations for years may not be a definitive future guaranty of whether calculations are accurate and compliant.

After all, while driving over 55 mph may not always result in getting a speeding ticket…**getting caught just once** can have dire and long-term consequences. The same metaphor applies for lending regulations.

* This White Paper references the CFPB's proposed Small Dollar Rule. The Bureau published their final Small Dollar Rule as this paper went to press. In publishing the final rule, the Bureau appears to have heeded some of the industry's concerns and revamped the more ominous provisions effecting traditional lenders. We are currently conducting a thorough review of the 1,690-page final rule. However, the proposed rule should not be overlooked. The proposed rule remains influential and states continue to attempt to mirror the all-in rate cap.