Federal ability-to-repay requirements for small dollar loans and other forms of non-mortgage lending

November 2021

Underwriting for ability to repay is at the core of responsible lending. The methods and extent of appropriate underwriting vary based on a number of factors, including the size and type of credit and the information available about the borrower's circumstances and history. **But every lender should take steps to reasonably ensure that the borrower will be able to afford to make payments as they come due while meeting existing obligations without reborrowing.**

Federal law establishes a number of requirements or expectations regarding lenders' consideration of ability to repay. For mortgage lending, the requirements are the most specific. For small dollar lending and other forms of non-mortgage lending, these are some of the applicable federal statutes, regulations and guidances that address appropriate underwriting to ensure responsible lending.

For all financial institutions, as well as lenders in partnership with financial institutions:

Board of Governors of the Federal Reserve System (FRB), Federal Deposit Insurance Corp. (FDIC), National Credit Union Administration (NCUA), Office of the Comptroller of the Currency (OCC), Interagency Lending Principles for Offering Responsible Small-Dollar Loans (May 2020). This set of principles discusses the general characteristics and principles of responsible small-dollar loan programs, including:

- "A high percentage of customers successfully repaying their small dollar loans in accordance with original loan terms, which is a key indicator of affordability, eligibility, and appropriate underwriting;
- "Repayment terms, pricing, and safeguards that minimize adverse customer outcomes, including cycles of debt due to rollovers or reborrowing; and
- "Repayment outcomes and program structures that enhance a borrower's financial capabilities."

The principles also emphasize:

- "Loan products are underwritten based on prudent policies and practices governing the amounts borrowed, frequency of borrowing, and repayment requirements…
- "Loan underwriting: Analysis that uses internal and/or external data sources, such as deposit account activity, to assess a customer's creditworthiness and to effectively manage credit risk. Such analysis may facilitate sound underwriting for credit offered to non-mainstream customers or customers temporarily impacted by natural disasters, national emergencies, or economic downturns. Underwriting can also use effectively managed new processes, technologies, and automation to lower the cost of providing responsible small-dollar loans."

FRB, FDIC, OCC, Office of Thrift Supervision (OTS), Expanded Guidance for Subprime Lending Programs (Jan. 31, 2001). This guidance discusses risk management for subprime lending and also regulatory expectations for the review and treatment of certain potentially abusive lending practices. It emphasizes that subprime lending that is “appropriately underwritten, priced, and administered” can service customers responsibly and enhance credit access. However, the agencies recognize that some forms of subprime lending may be “abusive or predatory”:

> “Some such lending practices appear to have been designed to transfer wealth from the borrower to the lender/loan originator without a commensurate exchange of value. This is sometimes accomplished when the lender structures a loan to a borrower who has little or no ability to repay the loan from sources other than the collateral pledged. When default occurs, the lender forecloses or otherwise takes possession of the borrower's property (generally the borrower's home or automobile). In other cases, the lender may use the threat of foreclosure/repossession to induce duress upon the borrower for payment. Typically, predatory lending involves at least one, and perhaps all three, of the following elements:
>
> - “Making unaffordable loans based on the assets of the borrower rather than on the borrower's ability to repay an obligation;
> - “Inducing a borrower to refinance a loan repeatedly in order to charge high points and fees each time the loan is refinanced ("loan flipping"); or
> - “Engaging in fraud or deception to conceal the true nature of the loan obligation, or ancillary products, from an unsuspecting or unsophisticated borrower.”
>
> “Loans to borrowers who do not demonstrate the capacity to repay the loan, as structured, from sources other than the collateral pledged are generally considered unsafe and unsound.”

For national banks and federal savings associations:

OCC Advisory Letter, Guidelines for National Banks to Guard Against Predatory and Abusive Lending Practices, AL 2003-2 (Feb. 21, 2003). AL 2003-2 focuses on mortgage lending but also discusses predatory lending generally. For example, the guidelines state:

> “[A] fundamental characteristic of predatory lending is the aggressive marketing of credit to prospective borrowers who simply cannot afford the credit on the terms being offered.….”

The guidelines also warn:

> “A national bank that makes a loan to a consumer based predominantly on the liquidation value of the borrower’s collateral, rather than on a determination of the borrower’s repayment ability, including current and expected income, current obligations, employment status, and other relevant financial resources, is engaging in a fundamentally unsafe and unsound banking practice that is inconsistent with established lending standards.”

OCC Advisory Letter, Title Loan Programs, AL 2000-11 (Nov. 27, 2000). AL 2000-11 focuses on auto title loans, but the principles are generally applicable. For example, the letter states: “Some title loans are made based on the value of the collateral and not on the borrower’s ability to repay the loan at its stated maturity. Such loans are inconsistent with safe and sound lending principles.”

OCC, Advisory Letter, Abusive Lending Practices, AL 2000-7 (July 25, 2000). AL 2000-7 discusses abusive lending practices generally. It emphasizes that bank examiners "should be alert for the following indications that an institution may be engaging in abusive lending practices" including "Collateral or Equity 'Stripping' - loans made in reliance on the liquidation value of the borrower's home or other collateral, rather than the borrower's independent ability to repay, with the possible or even intended result of foreclosure or the need to refinance under duress."

For all insured credit unions:

NCUA supervises all insured credit unions, both federally- and state-chartered, for safety and soundness. This supervision includes oversight of lending standards, and requires, *inter alia*, "adequate determination of the financial capacity of borrowers." 12 C.F.R. sec. 741.3(b)(2).

For federal credit unions:

NCUA has specific regulations governing payday alternative loans (PALs). In addition to the interest rate limits that apply to federal credit unions and PAL loans, the regulations include underwriting requirements:

> "Underwriting. Federal credit unions should develop minimum underwriting standards that account for a member's need for quickly available funds, while adhering to principles of responsible lending. Underwriting standards should address required documentation for proof of employment or income, including at least two recent paycheck stubs. Federal credit unions should be able to use a borrower's proof of recurring income as the key criterion in developing standards for maturity lengths and loan amounts so a borrower can manage repayment of the loan. For members with established accounts, federal credit unions should only need to review a member's account records and proof of recurring income or employment."

12 C.F.R. § 701.21(c)(7)(iii)(B) (2) (PALs I); *accord* 12 C.F.R. 701.21(c)(7)(iv)(B)(2) (similar standards for loans under PALs II).

NCUA also discussed underwriting standards when finalizing the first set of APL regulations:

> "While the Board has historically only provided guidance on minimum standards for determining a borrower's recurring income as the key criteria for eligibility for a PALs loan, that does not mean that an FCU may ignore a borrower's debt burden when determining whether to grant a PALs loan. Rather, the FCU must consider the borrower's entire financial position, including debt burden, and make an informed judgment consistent with responsible lending principles regarding whether to extend a PALs loan to a borrower. Accordingly, the FCU should conduct some inquiry into whether the borrower can manage to repay the PALs loan without the need for additional PALs loans or traditional payday loans. When considering the application of a member with prior a history at the credit union, a review of credit and debit activity in their account may be sufficient to make this determination."

NCUA, Payday Alternative Loans, Final Rule, 84 Fed. Reg. 51946-47 (Oct. 1, 2019).

For credit cards:

The Truth in Lending Act (TILA), as amended by the Credit Card Accountability Responsibility and Disclosure Act, provides:

> "A card issuer may not open any credit card account for any consumer under an open end consumer credit plan, or increase any credit limit applicable to such account, unless the card issuer considers the ability of the consumer to make the required payments under the terms of such account."

15 U.S.C. § 1665e. This provision is implemented by Regulation Z, 12 C.F.R. § 1026.51, and by Regulation Z Official interpretations 51(a) and 51(b). For example, Regulation Z states that credit card issuers must consider "the consumer's ability to make the required minimum periodic payments under the terms of the account based on the consumer's income or assets and the consumer's current obligations." 12 C.F.R. § 1026.51(a)(1)(i). It also provides:

> "Reasonable policies and procedures also include consideration of at least one of the following: The ratio of debt obligations to income; the ratio of debt obligations to assets; or the income the consumer will have after paying debt obligations. It would be unreasonable for a card issuer not to review any information about a consumer's income or assets and current obligations, or to issue a credit card to a consumer who does not have any income or assets."

Id. § 1026.51a(1)(ii).

For all loans and all lenders:

In addition to specific legal requirements addressing underwriting, both federal and state laws prohibiting unfair, deceptive, abusive or unconscionable practices also apply to lending practices. Lending without regard to ability to repay may be a violation of those laws. *See, e.g.,* National Consumer Law Center, Unfair and Deceptive Acts and Practices § 6.3 (9th ed. 2016).