CFPB's PROPOSED PAYDAY RULE IS BETTER WITHOUT LOOPHOLE BASED SOLELY ON A BORROWER'S INCOME

A limit on loan payment size of 5% of income will not ensure affordable loans and prevent borrower harm

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The Consumer Financial Protection Bureau's (CFPB) recently proposed rule to address payday and car title loans generally requires lenders to determine whether a borrower has the ability to repay a loan, without needing to reborrow and while continuing to meet other expenses. This common sense standard, critically, includes consideration of the borrower's income *and* expenses.

In the CFPB's outline of proposals under consideration released in 2015, the agency said that it was considering providing an exemption from the ability-to-repay requirement for longer-term loans of up to six months, so long as the loan's payments did not exceed 5% of a borrower's gross income (a payment-to-income, or PTI, ratio of 5% or less). That exemption is rightly not included in the formal rule proposed this June.

A rationale offered in support of a 5% PTI exemption is that it is needed to enable banks to make small-dollar loans to their more vulnerable customers, and that this competition is needed to move borrowers away from payday lenders. This does not hold up to scrutiny.

We oppose a 5% PTI exemption for the following reasons:

1. **The PTI limit was an exemption from an ability-to-repay test, not a safeguard.** The 5% PTI limit would have been an exemption from the rule's fundamental principle, ability to repay *based on income and expenses*.
2. **Payday loans with a 5% PTI limit are not necessarily affordable; in fact, very often they are not.**
   a. **Payday installment loans have very high defaults even when payments are limited to 5% of income or less.** CFPB's recently released large study finds that payday installment loans with payments of 5% of income or less are often unaffordable: They carry extraordinarily high *default rates averaging 28%-40%*.[1]
   b. **The large majority of payday loans are made to borrowers who likely cannot afford to pay 5% of their income toward additional debt.** CFPB's general ability-to-repay standard takes a "residual income" approach, meaning that it considers income and expenses, rather than a debt-to-income approach as used in other markets, and the CFPB explains why. Payday loans are made to borrowers with relatively low incomes,[2] for whom an assumption that debt is affordable based merely on the ratio of that debt to the borrower's income is less likely to be true.[3] Take, for example, a borrower earning $24,000 annually, $2000 monthly. A 5% PTI standard would assume that that borrower can afford $100 month, or $1,200 annually, toward service of payday loan debt, regardless of the borrower's existing debt load or challenges meeting regular expenses. This is far from a safe assumption.
   c. **The fact that lenders often collect approximately $100 in rollover payments each month is not evidence that the borrower can afford those payments.** Rollover payments are payments the lender collects from a borrower around payday to extend the loan until the next payday. They are typically the only way the borrower can prevent the lender from seizing the entire loan principal – a much larger payment – from the borrower's account on payday. So borrowers do not choose to pay rollover fees because they can afford them; they pay them in order to avoid even further difficulty meeting monthly expenses like rent and food. Yet even the rollover fees are not collected without distress to borrowers: Lenders trap borrowers deeper in debt over time, and for longer

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1 CFPB Supplemental Data released June 2, 2016, Fig. 6-12 http://files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf. CFPB's analysis of a large dataset uses a conservative definition of default, counting as defaulted loans only those charged off. p. 19.

2 Data suggest online payday installment loan borrowers have a median income of $30,000. CFPB Proposed Rule at FN 432, http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf.

3 CFPB Proposed Rule at 281-82: "DTI tests generally rest on the assumption that so long as a consumer's debt burden does not exceed a certain threshold percentage of the consumer's income, the remaining share of income will be sufficient for a consumer to be able meet non-debt obligations and other expenses. However, for low-and moderate-income consumers, the Bureau believes that assumption is less likely to be true: a DTI ratio that might seem quite reasonable for the "average" consumer can be quite unmanageable for a consumer at the lower end of the income spectrum and the higher end of the debt burden range [citation omitted]. Ultimately, whether a particular loan is affordable will depend upon how much money the consumer will have left after paying existing obligations and whether that amount is sufficient to cover the proposed new obligation while still meeting basic living expenses."

periods of time, suggesting even the rollover fees become too burdensome.[4] Further, CFPB found that half of payday borrowers incur an overdraft or bounced payment, with over a third of borrowers with a bounced payment having their account closed.[5] And finally, at least one in five borrowers ultimately default – likely often because they cannot sustain the rollover fees.[6]

3. **Unscrupulous lenders will exploit this standard.** Though it may be defended as a bank alternative, the exception would be permitted for any lender, and there is no reason to expect non-bank lenders will not continue making exorbitantly priced loans under this exemption while defending them as "responsible" based on the 5% PTI.
4. **Banks should not need special passes to make reasonably priced loans.** For many years, banks have made loans with pricing that would either exclude the loans from the proposed rule entirely or comply with the proposed rule as drafted, without a 5% PTI exemption.[7] More than 700 credit unions make loans under the existing NCUA "payday alternative loan" program.[8] The relatively low-cost and proven exemption for NCUA-like loans included in the proposed rule is much more affordable, and much safer, than a 5% PTI exemption.
5. **Better products will not drive out predatory ones.**
   a. **Research has repeatedly shown that there is generally no meaningful price competition among payday lenders.**[9] Payday lenders charge the maximum cost permitted under state law. They market aggressively, including paying online lead generators large finder's fees, the costs of which they support with very high rates and the debt trap. The predatory subprime loans leading to the mortgage crisis are evidence that good loans – which were long being made – do not drive out predatory ones. Rather, the opposite is true. Thus, baseline protections are needed to *prohibit* predatory loans; competition simply will not drive them out.
   b. **Bank revenue from predatory overdraft fees are likely the key reason banks don't offer better small-dollar loans to more of their vulnerable customers.** Banks make more than $14 billion annually in abusive overdraft fees, a large portion of which comes from the very same customers who may be able to benefit from an affordable small-dollar loan. Common sense regulations to address abusive overdraft fees would do far more to encourage better products than a PTI exemption from a critical ability-to-repay standard. And until such regulations are in place, banks have little incentive to offer something cheaper to their more vulnerable customers.
6. **A 5% PTI exemption undermines the FDIC and OCC's bank payday guidance.** The FDIC and OCC issued guidelines in 2013 which require that banks consider income and expenses when making payday loans repaid via the customer's checking account. These guidelines largely stopped banks from making abusive high-cost payday loans. An income-only standard is far weaker and puts the stronger guidelines at risk.
7. **A 5% PTI exemption would threaten strong state laws.** Over half of states have interest rate limits on longer-term loans. The sanctioning of a 5% PTI limit would give lenders a purported rationale to weaken or remove interest-rate limits, which are the proven strongest way to protect borrowers from abusive loans,[10] in favor of a PTI standard. This could result in weakened consumer protections across the country.

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[4] Center for Responsible Lending, *Payday Loans, Inc.: Short on Credit, Long on Debt* (2011) (finding that Oklahoma borrowers' typical loan size grew from $300 to $422, and that days in debt grew from 212 in the first year studied to 372 in the subsequent year). http://www.responsiblelending.org/payday-lending/research-analysis/payday-loans-inc-exec-summary.pdf.

[5] CFPB, Online Payday Loan Payments (April 2016), http://files.consumerfinance.gov/f/201604_cfpb_online-payday-loan-payments.pdf.

[6] CFPB Proposed Rule at 204, 254, based on CFPB's loan sequence analyses. CRL's *Payday Loans, Inc*., analysis found that 44% defaulted.

[7] In addition, CFPB notes that nearly three-fourths of banks responding to a recent community bank trade survey reported making loans of $1,000 or less. These loans typically charged 12% interest; one-third carried no origination/application fee, while two-thirds did. The large majority of these loans' underwriting included verification of major financial obligations and income. CFPB Proposed Rule at 98-100.

[8] CFPB Proposed Rule at 102.

[9] CFPB Proposed Rule at 276-77.

[10] CFPB Proposed Rule at 142: "The Bureau believes that the fee and interest rate caps in these States [that have them] would provide greater consumer protections than, and would not be inconsistent with, the requirements of the proposed rule." CFPB lacks statutory authority to set interest rate limits.