ASSESSING BOTH INCOME AND EXPENSES IS NECESSARY IN TEST OF BORROWER'S ABILITY TO AFFORD A CONSUMER LOAN

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A limit on loan payment size of 5% of income will not prevent borrower harm

Overview

As federal and state lawmakers and regulators work to rein in harmful debt-trap payday lending, a few parties have recommended a solution that the overwhelming majority of consumer advocates and research organizations find to be unhelpful. Basing reform of abusive consumer lending on limiting the payment to 5% of a borrower's income, while disregarding a borrower's expenses, allows payday lenders and others to continue trapping consumers in loans they cannot afford to pay off. This analysis outlines the weakness in this approach. A cap on interest rates of 36% or less is the most efficient and effective way to prevent predatory lenders from trapping families in a cycle of unaffordable debt.

The CFPB's New Payday and Car Title Lending Rule

The Consumer Financial Protection Bureau's (CFPB) recently finalized rule addressing 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.[1] This commonsense standard, critically, includes consideration of the borrower's income *and* expenses. The Consumer Bureau's rule applies to short-term loans as well as longer-term loans with large balloon payments; the CFPB has not yet finalized a rule applicable to longer-term loans without balloon payments.

Longer-term payday loans—or payday installment loans—are repaid over multiple installments instead of in one lump sum, but the lender is still first in line for repayment and thus lacks incentive to ensure the loans are affordable. These loans, often made by the same lenders that make lump sum-payment payday loans and that still carry triple-digit interest rates, can be as harmful, or even more harmful, than short-term, balloon payment payday loans.[2]

The CFPB Discarded the 5% Loophole, For Good Reason

While the Consumer Bureau has not finalized an ability-to-repay test applicable to longer-term payday loans, its proposed rule from 2016 would have required that ability-to-repay determinations for those loans also be based on a borrower's income and expenses. In its preliminary outline of a payday rule from 2015, the CFPB considered an exception to the rule's ability-to-repay requirements for certain 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). But the Bureau later decided against including that exemption in its formal proposed rule, and rightly so. **A 5% PTI approach, which ignores the expenses of borrowers who are typically lower-income and financially distressed, would not prevent unaffordable loans or consequent harm to borrowers.**

Threat from Bank Regulators – Will Bank Payday Lending Rise Again?

While the CFPB did not adopt this 5% PTI loophole, there remains risk that federal banking agencies (the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board, and the National Credit Union Administration (NCUA)), as well as state lawmakers, could endorse a loophole along these lines for the depositories they regulate or, in the case of state lawmakers, nonbank lenders. This 5% PTI proposal has been endorsed by the Pew Charitable Trusts and by some banks, including three of the six that were making payday loans until federal guidance resulted in banks' generally discontinuing their payday loans in 2013.[3] **The 5% PTI proposal would open the door for lenders to make unaffordable long-term payday loans.**

Why The 5% PTI Test is a Flawed Idea

Rationales offered in support of a 5% PTI approach include (1) that it is needed to enable banks and credit unions to make small-dollar loans to their more vulnerable customers, and (2) that explicitly permitting loans with a 5% PTI limit will create competition, resulting in borrowers' moving from more expensive payday loans into less expensive ones. These rationales do not hold up to scrutiny.

National consumer rights, civil rights, faith organizations and others oppose a 5% PTI loophole for the following reasons:

1. **The PTI limit represents an exemption from an ability-to-repay determination, not a safeguard.** The 5% PTI limit included in CFPB's 2015 preliminary outline would have been an exemption from the rule's fundamental principle: ability to repay based on income and expenses.
2. **Loans with a 5% PTI limit will likely be unaffordable for distressed borrowers:**
    a. **The large majority of payday loans are made to borrowers who likely cannot afford to pay 5% of their income toward additional debt.** For individuals with relatively low incomes—which is typically the case for payday loan borrowers[4]—an assumption that debt is affordable based merely on the ratio of that debt to the borrower's income is not a safe assumption. Consider a family of four at the federal poverty level of $24,300 annually, $2,025 monthly. A 5% PTI standard would assume that the borrower has an extra $101 each month, or $1,215 annually, that they can spare toward service of payday loan debt. Even under the best circumstances, this often will not be the reality. And the PTI standard ignores altogether exacerbating factors like the family's existing debt load or challenges meeting regular expenses.

    b. **Payday installment loans have very high defaults even when payments are limited to 5% of income or less.** CFPB's research found extraordinarily high default levels on online installment loans even at PTI ratios of 5% or less. For one lender in the Bureau's data whose loans included both storefront and online loans, 28 to 30% of loans with PTI of 5% of less defaulted, excluding loans with first-payment defaults.[5] For all loans for which the origination channel was unknown—about half the dataset, or 1.25 of 2.5 million loans—the Bureau found default rates of 38 to 40% at PTI of 5% or less, including first-payment defaults.[6]

c. **CRL's analysis of checking account data shows that even small payday loan payments often cause financial distress.** CRL analyzed online payday loan payments from a database of consumer checking account activity for its 2015 paper, *Payday Mayday*.[7] The payday loan payment sizes in this panel were typically much smaller than a typical payday balloon payment, with about 42% of all the payments less than $100. Yet the analysis found that payments even at these smaller dollar amounts were often associated with significant borrower distress, as evidenced by non-sufficient fund/overdraft activity occurring on the borrower's checking account in the two weeks following the payday loan payment. Many of the payday payments that were associated closely in time with an overdraft were for small amounts: Half were $100 or less and over a third were $50 or less.[8]

d. **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: 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.[9] And finally, at least one in five borrowers ultimately default – likely often because they cannot sustain the rollover fees.[10]

3. **A 5% PTI standard does not limit interest rates, will facilitate high-cost loans, and will be used to undermine interest rate caps.** A 5% PTI limit is not an interest rate limit. By sanctioning 5% PTI, non-cost restricted loans, banking regulators would not only permit high-cost unaffordable lending by banks, but they risk *bolstering* predatory lending by non-banks. Over half of states have interest rate limits on longer-term loans,[11] but the sanctioning of a 5% PTI limit would give lenders a purported rationale for weakening or removing effective interest-rate limits, or not establishing them in states without current limits, in favor of a weak PTI standard. This could result in weakened consumer protections across the country.

4. **Banks and credit unions should not need special passes to make reasonably priced loans.** Banks have had the option for decades to make more affordable installment loans, and they don't need a 5% PTI exemption to do so now. Indeed, many depositories already make affordable installment loans, without a 5% PTI exemption.[12]In addition, about 650 credit unions make loans under the existing NCUA "payday alternative loan" program.[13]

5. **There is reason to expect banks to drive up a PTI limit to higher than 5%.** While the American Bankers Association has endorsed a payment-to-income standard, it has expressed substantial doubt that 5% is high enough to induce banks to make the loans.[14] Individual banks that have expressed interest in a 5% PTI standard, as well as other bank trade associations endorsing it, have also hedged, stating that "experience may suggest that a

different percentage is appropriate over time."[15]

6. **Better products will not drive out predatory ones.** Evidence suggests that competition does not drive out predatory practices. Responsible mortgage loans, which were long being made, did not drive out the predatory subprime loans that lead to the foreclosure crisis. Reasonably priced credit cards did not keep out the abusive subprime fee harvester cards that proliferated prior to 2008 regulatory and Congressional interventions. To the contrary, bad products keep out better ones. So long as banks can continue to generate $17 billion annually in overdraft and nonsufficient fund fees, much of which is from the same financially vulnerable customers who might take payday installment loans, it is unlikely banks will markedly increase reasonably priced small dollar lending to those customers. (A CFPB rulemaking is needed to address overdraft abuses.)[16]

Federal and State Lawmakers Should Cap Annual Interest at 36% or Less

The Consumer Bureau's rule is a necessary step in addressing the debt trap of payday lending, and importantly includes expenses in the test of a borrower's ability to afford the loan. But a rate cap, which the Bureau is not legally authorized to set, is the strongest protection for consumers. Fifteen states and the District of Columbia have adopted rate caps of 36% or less, which have been successful in stopping the payday loan debt trap. Arizona, Montana, Ohio, and South Dakota, in particular, instituted rate caps through a ballot vote, directly reflecting their citizen's desire to reject the debt trap. Additionally, Congress, at the urging of the U.S. Department of Defense, has adopted a 36% rate cap to protect military personnel and their families.

The #StopTheDebtTrap campaign is powered by more than 500 civil rights, consumer, labor, faith, veterans, seniors and community organizations from all 50 states. Analysis provided by the Center for Responsible Lending.

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[1] Consumer Financial Protection Bureau, *Payday, Vehicle Title, and Certain High-Cost Installment Loans, Final Rule* (Oct. 5, 2017), https://www.consumerfinance.gov/policy-compliance/rulemaking/final-rules/payday-vehicle-title-and-certain-high-cost-installment-loans/ (CFPB Final Rule).

[2] Diane Standaert and Peter Smith, *Payday and Car Title Lenders' Migration to Unsafe Installment Loans*, Center for Responsible Lending at 1 (Oct. 2015) *available at*http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/crl_brief_cartitle_lenders_migrate_to_installmentloans.pdf; CRL/CFA/NCLC Comments on CFPB Proposed Rule, Sec. 10, p. 165 and following; CFPB Proposed Rule, Market Concerns—Longer-Term Loans.

[3] This guidance was issued by the OCC and the FDIC. The OCC rescinded its guidance in October 2017; *see* OCC News Release NR 2017-118 (Oct. 5, 2017), https://www.occ.treas.gov/news-issuances/news-releases/2017/nr-occ-2017-118.html.

[4] Median incomes for these borrowers are in the $25,000-$30,000 range, while closer to $35,000 for online borrowers. *See* CFPB Final Rule.

[5] CFPB, Supplemental Findings on payday, payday installment, and vehicle title loans, and deposit advance products (June 2016), https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/Supplemental_Report_060116.pdf, at 17 (Figure 6), 22 (Figure 9) and n.31 at 24. CFPB's analysis of a large dataset uses a conservative definition of default, counting as defaulted loans only those charged off. *Id*. at 19. In addition, the Bureau excluded from this analysis

loans with defaults before the first payment. This results in a conservative defaults figure, particularly considering that some portion of first payment defaults are due to inability to repay. At the same time, we note, as the Bureau does, that a nonprime 101 study found that the statistical correlation between PTI and defaults was substantially mitigated or eliminated when first-payment defaults were eliminated.

[6] CFPB Supplemental Findings at 18, 23, 24.

[7] Susanna Montezemolo & Sarah Wolff, *Payday Mayday: Visible and Invisible Payday Lending Defaults*, Center for Responsible Lending (March 2015), http://www.responsiblelending.org/research-publication/payday-mayday-visible-and. To conduct this analysis, we used a national sample of checking account transaction data. We identified instances where accountholders had overdraft fees assessed within two weeks of a payday payment and isolated the payday payment that fell closest in time to the overdraft (in some cases accountholders had either multiple payday payments or multiple overdrafts in this period). We then looked at the distribution of the amounts of the payments.

[8] Analysis on file with CRL.

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

[10] CFPB Final Rule at 309; CRL research has found a 44% default rate, *Payday* Center for Responsible Lending, *Payday Loans, Inc.: Short on Credit, Long on Debt* (2011), http://www.responsiblelending.org/payday-lending/research-analysis/payday-loans-inc-exec-summary.pdf. This research also found 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,

[11] *See* National Consumer Law Center, Installment Loans: Will States Protect Borrowers from a New Wave of Predatory Lending? (July 2015), https://www.nclc.org/images/pdf/pr-reports/report-installment-loans.pdf.

[12] Nearly three-fourths of banks responding to a 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. Bureau of Consumer Protection, 12 CFR Part 1041, Payday, Vehicle Title, and Certain High-Cost Installment Loans; Proposed Rule, 81 Fed. Reg. 47864, 47891 (July 22, 2016), *available at* https://www.gpo.gov/fdsys/pkg/FR-2016-07-22/pdf/2016-13490.pdf (CFPB Proposed Rule).

[13] CFPB Final Rule at 85.

[14] *See* ABA Comment to CFPB on CFPB Proposed Rule (Oct. 7, 2016), http://www.aba.com/Advocacy/commentletters/Documents/cl-SmallDollar-2016.pdf: "It is not clear, however, whether a 5% PTI standard would allow banks to earn a reasonable return on the small dollar loans made under this framework, sufficient to justify expanded bank offerings. Further market testing may help identify the level of such a PTI standard that would elicit the optimal supply of small dollar credit. Any rules ultimately adopted should afford interested market participants with room to experiment with a PTI approach. Moreover, because of the variability of cost structures, operating efficiencies, and customer default risk, we believe that rules should permit variability in the payment to income ratio."

Notably, one of the banks most out-front urging more permissive rules in this space is Fifth Third, one of only six banks that made payday loans, and the only bank to continue to make these loans after the 2013 guidance, at a cost of $3 per $100 to customers already enrolled in the product as of Jan. 31, 2014. *See* Yuka Hayashi, *Banks Want a Piece of the Payday-Loan Pie*, Wall Street Journal (May 20, 2017) *available at* https://www.wsj.com/article_email/banks-want-a-piece-of-the-payday-loan-pie-1495281601-lMyQjAxMTE3MjI0MDEyNjA1Wj/?mg=prod/accounts-wsj.

[15] Letter to CFPB endorsing a 5% PTI standard signed by Guaranty Bank, Regions Bank, and Fifth Third Bank, and Pew, among others, Oct. 6, 2017, *available at* https://www.regulations.gov/document?D=CFPB-2016-0025-142119 (noting "[a]vailable evidence suggests that a 5 percent payment-to-income ratio is suitable from the borrower's and the lender's perspectives, but these are new products and experience may suggest that a different percentage is appropriate over time.")

[16] For further discussion on overdraft fees, including quantification of the $17 billion estimate and policy recommendations, *see, generally*, Rebecca Borné, Peter Smith, and Rachel Anderson, *Broken Banking*: *How Overdraft Fees Harm Consumers and Discourage Responsible Banking Products*, Center for Responsible Lending (May 24, 2016), *available at* http://www.responsiblelending.org/research-publication/how-overdraft-fees-harm-consumers-and-discourage-responsible-bank-products.