Consumer Financial Protection Bureau

June 2, 2016

CONSUMER FINANCIAL PROTECTION BUREAU PROPOSES RULE TO END PAYDAY DEBT TRAPS

The Consumer Financial Protection Bureau (CFPB) today proposed a rule aimed at ending payday debt traps by requiring lenders to take steps to make sure consumers have the ability to repay their loans. The proposed rule would also cut off repeated debit attempts that rack up fees. These strong proposed protections would cover payday loans, auto title loans, deposit advance products, and certain high-cost installment and open-end loans. The CFPB is also launching an inquiry into other products and practices that may harm consumers facing cash shortfalls.

BACKGROUND ON PAYDAY, AUTO TITLE, AND CERTAIN HIGH-COST INSTALLMENT LOANS

The proposed rule would apply to certain short-term and longer-term credit products that are aimed at financially vulnerable consumers. Short-term loans are often described as a way for consumers to bridge a cash flow shortage between paychecks or the receipt of other income. These loans are typically due within two weeks to a month after being made. Longer-term loans are typically repaid in multiple payments over a period of months or years. All lenders would be subject to the CFPB's proposed requirements for any loan they make that's covered by the proposal. This includes banks, credit unions, and nonbanks. Lenders would be required to comply regardless of whether they operate online or out of storefronts and regardless of the types of state licenses they may hold. Loans covered by the proposal include:

- **Payday and other short-term credit products**: Payday loans are generally due on the borrower's next payday, which most often is within two weeks, and typically have an average annual percentage rate of around 390 percent or even higher. Single-payment auto title loans, which require borrowers to use their vehicle title for collateral, are usually due in 30 days with a typical annual percentage rate of about 300 percent. Most consumers end up renewing these short-term loans when they come due or reborrowing within a short period of time. The consumer pays more fees and interest each time they reborrow, turning a short-term loan over time into a long-term debt trap.

- **High-cost installment loans**: The proposal would cover loans for which the lender charges a total, all-in annual percentage rate that exceeds 36 percent, including add-on charges, and either collects payment by accessing the consumer's deposit account or paycheck or secures the loan by holding title to the consumer's vehicle as collateral. Some of the installment loans covered by the proposal have balloon, or lump-sum, payments required after a number of interest-only payments.

Debt Trap Dangers

The Bureau has serious concerns that risky lender practices in the payday, auto title, and payday installment markets are pushing borrowers into debt traps. Chief among these concerns is that consumers are being set up to fail with loan payments that they are unable to repay. Faced with unaffordable payments, consumers must choose between defaulting, reborrowing, or skipping other financial obligations like rent or basic living expenses like food and medical care. The CFPB is concerned that these practices also lead to collateral damage to other aspects of consumers' lives such as steep penalty fees, bank account closures, and vehicle seizures. Some of the debt trap dangers addressed in the proposed rule include:

- **Repeat short-term borrowing:** Reborrowing occurs when a consumer pays new fees to extend the loan for a longer period of time, or when a subsequent loan is taken soon after repayment. CFPB research shows that more than four-in-five short-term loans are reborrowed within a month. The majority of short-term loans are borrowed by consumers who take out a least ten loans in a row.

- **Default:** Default is the failure to repay a loan. After defaulting, some borrowers may become subject to aggressive and harmful debt collection efforts. Twenty percent of payday loan sequences end up in default, often after one or more instances of reborrowing. In addition, the Bureau's study of several payday installment and auto title installment lenders found that more than one-third of payday installment loan sequences and almost one-third of auto title installment loan sequences end in default, sometimes after the consumer has already refinanced or reborrowed at least once.

- **Auto Seizure**: Auto title loan borrowers who cannot repay the initial loan, which typically lasts 30 days, must reborrow or risk losing their vehicle. Losing access to a car or truck can have serious consequences for the consumer's ability to get to work or take care of health issues. CFPB research has found that one-in-five single-payment auto title loan borrowers ends up having their car or truck seized by the lender for failing to repay their loan. For auto title installment loans, 11 percent of loan sequences end up with consumers losing their vehicle.

- **Penalty Fees**: Attempts by online payday and payday installment lenders to debit payments from a consumer's checking account add a steep, hidden cost to online payday loans. CFPB research found that, over a period of 18 months, half of online borrowers have at least one debit attempt that overdrafts or fails. These borrowers incur an average of $185 in bank penalty fees, in addition to any fees the lender might charge for failed debit attempts, specifically, a late fee, a returned-payment fee, or both.
- **Account Closure:** A bank account may be closed by the depository institution for reasons such as having a negative balance for an extended period of time. CFPB research found that 36 percent of accounts with a failed debit attempt from an online lender ended up being closed by the depository institution. This happened usually within 90 days of the first insufficient funds transaction.

PROPOSAL TO END DEBT TRAPS

The CFPB is proposing a rule that would put an end to the risky practices in these markets that trap consumers in debt they cannot afford. The proposed ability-to-repay protections include a "full-payment" test that would require lenders to determine upfront that consumers can afford to repay their loans without reborrowing. The proposal includes a "principal payoff option" for certain short-term loans and two less risky longer-term lending options so that borrowers who may not meet the full-payment test can access credit without getting trapped in debt. Lenders would be required to use credit reporting systems to report and obtain information on certain loans covered by the proposal. The proposal would also limit repeated debit attempts that can rack up more fees and make it harder for consumers to get out of debt. These protections would be in addition to existing requirements under state or tribal law.

Full-Payment Test

Under the proposed full-payment test, lenders would be required to make an upfront determination of a consumer's ability to repay the loan. Before offering a loan, lenders would be required to check if the borrower can afford to pay the full amount of each payment owed when it's due, whether as a lump sum or an installment. The full-payment test includes the following:

- **Requirements for determining affordability:** Lenders would have to determine whether the borrower will have enough income to afford the loan, meet the consumer's major financial obligations, and still pay basic living expenses, like food and utilities. Lenders would be required to verify the amount of income that a consumer receives, after taxes, from employment, government benefits, or other sources. In addition, lenders would be required to check a consumer's credit report to verify the amount of outstanding loans and required payments.

  - ***Payday and single payment auto title****:* For short-term loans, lenders would be required to determine that the borrower has sufficient income to pay the loans and to meet major financial obligations and basic living expenses during the term of the loan and for 30 days after paying off the loan or paying the loan's highest payment.

  - ***High-cost installment loans****:* For installment loans with a balloon payment, lenders would be required to ensure a borrower can pay all of the payments when due, including the balloon payment, as well as major financial obligations and basic living expenses during the term of the loan and for 30 days after paying the loan's highest payment. For installment loans without a balloon payment, lenders would be required to determine that a borrower can pay all of the installment payments when due, as well as major financial obligations and basic living expenses during the loan's term.

- **Requirements for justifying additional loans:** The proposal would further protect against debt traps by making it difficult for lenders to push distressed borrowers into reborrowing or refinancing the same debt.

  - ***Payday and single-payment auto title****:* If a borrower seeks to roll over a loan or returns within 30 days after paying off a previous short-term debt, the lender would be restricted from offering a similar loan. Lenders could only offer a similar short-term loan if a borrower demonstrated that their financial situation during the term of the new loan would be materially improved relative to what it was since the prior loan was made. The same test would apply if the consumer sought a third loan. Even if a borrower's finances improved enough for a lender to justify making a second and third loan, loans would be capped at three in succession followed by a mandatory 30-day cooling off period.

  - ***High-cost installment loans****:* For consumers struggling to make payments under a payday installment or auto title installment loan, lenders could not refinance the loan into a loan with similar payments unless a borrower demonstrated that their financial situation during the term of the new loan would be materially improved relative to what it was during the prior 30 days. The lender could offer to refinance if that would result in substantially smaller payments or would substantially lower the total cost of the consumer's credit.

Principal Payoff Option for Certain Short-Term Loans

Under the proposal, consumers could take out a short-term loan up to $500 without the full-payment test as part of the principal payoff option that is directly structured to keep consumers from being trapped in debt. This option would be restricted to lower-risk situations and would require the debt to be repaid either in a single payment or with up to two extensions where the principal is paid down at each step. The specific parameters of the principal payoff option include:

- **Restricted to lower-risk situations:** Under this option, consumers could borrow no more than $500 for an initial loan. Lenders would be barred from taking auto title as collateral and structuring the loan as open-end credit. Lenders would also be barred from offering the option to consumers who have outstanding short-term or balloon-payment loans or have been in debt on short-term loans more than 90 days in a rolling 12-month period.
- **Debt is paid off:** As part of the principal payoff option, the lender could offer a borrower up to two extensions of the loan, but only if the borrower pays off at least one-third of the principal with each extension. This proposed principal reduction feature is intended to steadily reduce consumers' debt burden, allowing consumers to pay off the original loan in more manageable amounts to avoid a debt trap.
- **Debt risks are disclosed**: The proposal would require a lender to provide notices before making a loan under the principal payoff option. These notices must use plain language to inform consumers about elements of the option.

Reporting Requirements

The proposal would require lenders to use credit reporting systems to report and obtain information about loans made under the full-payment test or the principal payoff option. These systems would be considered consumer reporting companies, subject to applicable federal laws, and registered with the CFPB. Lenders would be required to report basic loan information, and updates to that information.

Less Risky Longer-Term Loan Option

The proposal would also permit lenders to offer two longer-term loan options with more flexible underwriting, but only if they pose less risk by adhering to certain restrictions. The first option would be offering loans that generally meet the parameters of the National Credit Union Administration "payday alternative loans" program where interest rates are capped at 28 percent and the application fee is no more than $20. The other option would be offering loans that are payable in roughly equal payments with terms not to exceed two years and with an all-in cost of 36 percent or less, not including a reasonable origination fee, so long as the lender's projected default rate on these loans is 5 percent or less. The lender would have to refund the origination fees any year that the default rate exceeds 5 percent. Lenders would be limited as to how many of either type of loan they could make per consumer per year.

Penalty Fee Prevention

Repeated unsuccessful withdrawal attempts by lenders to collect payment from consumers' accounts can pile on insufficient fund fees for consumers from their financial institution and prompt returned payment fees from the lender. A CFPB study over an 18-month period found that half of online payday and payday installment borrowers racked up penalty fees. These consumers were charged $185 in bank penalties on average from debit failures or overdrafts. More than one-third of borrowers with a failed payment ultimately lost their account. The following protections would apply to all loans covered by the proposal:

- **Written notice**: Lenders would have to give consumers written notice before attempting to debit the consumer's account to collect payment for any loan covered by the proposed rule. This notice, which generally would be delivered at least three days before the withdrawal attempt, would alert consumers to the timing, amount, and channel of the forthcoming payment transfer. If the payment transfer would be for a different amount, at a different time, or through a different payment channel than the consumer might have expected based upon past practice, the notice would specifically alert the consumer to the change. The Bureau believes the proposed required notice would help to reduce harm that may occur from a debit attempt by alerting the consumers to the upcoming attempt in sufficient time for them to contact the lender or the consumer's bank if there are any mistakes. It would also allow them time to make arrangements to cover payments that are due.

- **Debit attempt cutoff**: After two straight unsuccessful attempts, the lender would be prohibited from debiting the account again unless the lender gets a new and specific authorization from the borrower to again debit the account. An unsuccessful attempt includes a debit or withdrawal that is returned unpaid or is declined due to insufficient funds in the borrower's account. The lender would be required to obtain a borrower's new and specific authorization to make additional debits from the account. The CFPB's research has found that this limit on the number of times a lender could attempt to obtain payment would prevent the borrower from being assessed between $64 and $87 in overdraft or insufficient funds fees.

The CFPB's proposal is available at:
http://files.consumerfinance.gov/f/documents/Rulemaking_Payday_Vehicle_Title_Certain_High-Cost_Installment_Loans.pdf

INQUIRY INTO EMERGING RISKS

Today, the CFPB is also launching an inquiry into other potentially high-risk loan products and practices that are not specifically covered by the proposed rule. The Request for Information specifically focuses on:

- **Concerns about risky products not covered:** The Bureau is seeking information about forms of non-covered loans such as high-cost, longer-duration installment loans and open-end lines of credit where the lender does not take a vehicle title as collateral or gain account access. The CFPB's inquiry seeks information about the range and volume of installment and open-end credit products that are offered in this market, their pricing structures, and lenders' practices with regard to underwriting. The Bureau is also interested in learning whether these loans keep borrowers in long-term debt with a structure where borrowers pay down little to no principal for an extraordinarily long period.

- **Concerns about risky practices not covered:** The Bureau seeks to learn more about practices that can impact borrowers' ability to pay back their debt. This includes methods lenders may use to seize borrowers' wages, funds, vehicles, or other forms of personal property in a way that could pose consumer protection concerns. The Bureau is also interested in learning more about the sales and marketing practices of credit insurance, debt suspension or debt cancellation agreements, and other add-on products. Other practices subject to the inquiry include loan churning, default interest rates, teaser rates, prepayment penalties, and late-payment penalties.

The Request for Information is available at:
http://files.consumerfinance.gov/f/documents/RFI_Payday_Loans_Vehicle_Title_Loans_Installment_Loans_Open-End_Credit.pdf

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The Consumer Financial Protection Bureau is a 21st century agency that helps consumer finance markets work by making rules more effective, by consistently and fairly enforcing those rules, and by empowering consumers to take more control over their economic lives. For more information, visit consumerfinance.gov.