Initial Analysis of CFPB's Proposed Rule to Address Payday & Car Title Loans

June 6, 2016

The following provides an overview of CFPB's proposed rule to address payday and car title lending and CRL's initial reactions to it. As we review the proposal more closely, our initial reactions may evolve. Beginning in Part II., summary of the rule's provisions are in regular type, while CRL's reactions are *italicized*.

I. Overview

A. Overall Reaction

The proposed rule takes the right general approach by establishing an ability-to-repay principle – including consideration of income *and* expenses – at its core. This is extremely significant; while a long-standing tenet of responsible lending, it is one ignored by these abusive industries driven by unaffordable loans. It is a particularly important standard for high-cost loans where lenders have the right to seize a borrower's bank account or car.

At the same time, the proposal as drafted contains significant loopholes that abusive lenders can exploit to continue to prey on vulnerable people:

- **Exceptions to the ability-to-repay requirement**: The proposal exempts six high-cost payday loans from an ability-to-repay requirement altogether. Even a single unaffordable loan can create a cascade of financial consequences for borrowers. There are also exceptions for certain long-term loans, including loans that carry fees, in addition to periodic interest, of $50 or more.
- **Repeated flipping of loans**: The waiting period between loans has been reduced from 60 days in the 2015 preliminary proposal to 30 days in the proposed rule. This waiting period is aimed at addressing unaffordable reborrowing after a balloon payment (on a short-term loan or a long-term balloon loan). Protections against repeat refinancing of longer term loans without a balloon are particularly weak, sanctioning repeat refinancing early in the loan term, even if the borrower is up to seven days delinquent. Loopholes in the long-term portion of the rule are particularly concerning because lenders, anticipating stricter rules on short-term loans, are increasingly making long-term loans, which can create even longer and deeper debt traps than short-term loans.
- **"Business as usual" loopholes in the ability-to-repay requirement**: The rule does not go far enough to ensure that, after repaying the loan, the borrower will have enough money left over to pay basic living expenses without reborrowing. While the rule prohibits implausibly low estimates of living expenses, the proposal appears to require only that the lender not have default or reborrowing rates above those of other high cost lenders – sanctioning a bar that is too low. Moreover, even low rates of default and reborrowing are not sufficient evidence that loans are affordable since lenders seize repayment directly from the account (and even if the payment overdraws the borrower's account).

To close these and other loopholes discussed below, we urge CFPB to:

- Require an ability-to-repay determination on every loan, with no exceptions.
- Restore the 60-day waiting period after balloon-payment loans.
- Limit total indebtedness in **all** short-term loans – which have been exempted from some state interest rate caps based on lenders' claims that they are intended to be for very short terms – to 90 days per year, consistent with the long-time FDIC's standard.
- Strengthen protections against flipping loans, especially for loans longer than 45 days, by limiting refinancing unless the borrower has repaid 75% of the loan and restricting repeat refinancing.
- Close the "business as usual" loopholes in the ability-to-repay test by requiring lenders to show that loan payments will leave borrowers with enough money to be able to pay their necessary expenses.
- Make clear that industry-wide default, reborrowing, and bounced payment rates are far from acceptable, and that default rates should be low, particularly in light of the lender's extraordinary leverage to collect.
- Cover all loans that provide lenders extraordinary leverage to extract repayment, including loans where the lender obtains access to the borrower's bank account even after the first few days of the loan term, loans secured by personal property, and loans where the lender retains the right to garnish wages.

B. Key Changes Versus the 2015 Preliminary Proposal

The proposed rule differs from the 2015 preliminary proposal in several material respects, including:

What's Weaker?

- **Reduced waiting period on short-term loans**. On short-term loans, the rule now makes it easier for lenders to trap borrowers because it cuts the waiting period between loans in half, from 60 days to 30 days. This change, combined with the six "exception loans," could permit lenders to continue putting borrowers in 10 or more payday loans in a year.
- **Loopholes in the ability-to-repay test**. More details provided regarding the ability-to-repay test create concerns about the loopholes noted above.

What's Stronger?

- **Removal of the long-term 5% payment-to-income (PTI) exemption**. The preliminary proposal would have permitted high-cost lenders to avoid the ability-to-repay requirements for loans up to six months long if payments did not exceed five percent of a borrower's income. We were concerned that this approach, which disregarded a borrower's expenses, would not prevent unaffordable loans and resulting harm to borrowers. This concern is reinforced by CFPB's newly published research, which shows a default rate of 40 percent on longer-term payday loans even with payments of 5% of income or less.

- **Cushion required for long-term loans**. The proposed rule requires that longer-term loans have a cushion of residual income to account for income or expense volatility.

C. Importance of State Interest Rate Limits

The preamble to the proposal states that state usury limits are more protective of consumers than the rule's provisions will be, and we agree. Fourteen states plus the District of Columbia have interest rate limits that effectively prevent short-term payday lending, and more than half of states have interest rate limits on longer-term loans. In his comments announcing the proposed rule, Director Cordray emphasized that these "usury caps . . . effectively permit only small-dollar loans that are carefully underwritten." The Bureau's focus on ability-to-repay rules for high-cost loans is right in light of its statutory lack of authority to set a usury limit.

But states can and should cap interest rates at 36%, which is a simpler, stronger and more effective way to protect consumers.

II. Scope

The proposal addresses two categories of loans based on loan term: all short-term loans (45 days or less); and longer-term loans (more than 45 days) where (i) the lender, within 72 hours of disbursement of the loan proceeds, takes access to a leveraged payment mechanism (a post-dated check, electronic debit authorization, or a car title) and (ii) the all-in, fee-inclusive APR is greater than 36%.

CRL supports inclusion of short-term and long-term loans as both appropriate to address existing abuses and necessary to prevent foreseeable lender efforts at evasion. However, we are concerned that the long-term scope will be too easily evaded. We urge that long-term loans be defined more broadly to include (1) loans where the lender takes access to the borrower's bank account or car title after 72 hours; (2) loans secured by personal property or where the lender retains the right to garnish wages; and (3) credit cards that do not meet the requirements of the Military Lending Act regulations.

III. Ability-to-Repay Standard

A. Ability to repay (ATR) means the ability to repay the loan, while continuing to meet other major financial obligations and basic living expenses, without needing to reborrow.

B. The determination of ATR requires consideration of the following for both short- and long-term loans. In addition, both short- and long-term loans have additional unique considerations, which are explained in Parts IV. and V. of this memo, respectively.

   1. income, which must be verified;
   2. major financial obligations including:
      a. housing expense, either verified or using a reliable locality-based estimate;
      b. minimum payments on other debt obligations based on (1) a national credit report and (2) a report from a "registered information system" to which covered loans will generally be reported; and
      c. court- or government agency-ordered child support obligations;

3. basic living expenses—expenses necessary to maintain health, welfare, and ability to produce income for borrower and household. Basic living expenses may be forecasted, and the rule provides examples of reasonable and unreasonable forecasting methods:
   a. **"**reasonable methods**"** include:
      i. using a minimum percentage of income or a dollar amount from a statistically valid survey that takes into account income, location, and household size;
      ii. obtaining additional reliable information beyond the required information for major financial obligations to develop the estimate; or
      iii. any method that reliably predicts basic living expenses;
   b. **"**unreasonable methods**"** include:
      i. assuming no or implausibly low basic living expenses; or
      ii. setting minimum percentages of income or dollar amount that have yielded high default or reborrowing rates relative to other lenders' loans to similarly situated consumers.

C. For income and major financial obligations, the lender also must obtain a written statement from the borrower of these amounts and timing. The lender may use the stated amounts instead of verified amounts in certain circumstances (for which the proposal provides examples) to the extent the stated amounts are deemed consistent with the verified amounts. In making this determination, the lender may reasonably consider reliable evidence, including explanations from the consumer.

D. Evidence of whether ATR determinations are reasonable may include the lender's rates of delinquency, default, and reborrowing, including how those compare to rates of other lenders making similar loans to similarly situated consumers.

CRL strongly supports the general long-standing definition of ATR. CRL agrees with the Bureau's analysis that an approach to underwriting based on income and expenses, as opposed to, for example, a debt-to-income approach, is the most appropriate for the relatively low-income borrowers likely to be issued covered loans. CRL supports required verification of income, verified documentation of major financial obligations, and consideration of basic living expenses. We also generally support consideration of high rates of defaults, delinquency, and reborrowing as strong evidence of inability to repay, particularly in light of the lenders' extraordinary leverage.

We strongly oppose the following elements of the test, which we are concerned create loopholes that would severely undermine the ATR requirement and risk permitting business as usual:

- *Permitting an assumption for basic living expenses based on a percent of income, a minimum dollar amount, or other factors, rather than based on objective estimates of how much consumers actually need.*
- *Evaluating the effectiveness of an ability-to-pay methodology based on loan performance as compared to other high-rate lenders.*

We also urge that rates of bounced payments, the aggressiveness of the lender's debt collection practices, and other factors be considered in assessing the affordability of the loans.

IV. Short-term (ST) Loans

A. Scope:

1. Generally, terms of 45 days or less;
2. Can include loans with longer terms and open-end loans if substantial repayment is due within 45 days;
3. Certain protections applicable to ST loans also apply to a subcategory of a loans longer than 45 days that include a balloon payment (LTB loans), where balloon is defined as a payment at least twice as large as any other payment.

CRL supports a far broader definition of balloon payment loan for these relatively small dollar loans to distressed borrowers, where payment shock can be severe. It should be any loan where all payments are not substantially equal.

B. Rule: Lender may make loans subject to an ability-to-repay determination (ATR Loans) and/or "exception loans" in accordance with their respective requirements. One borrower could be made both ATR and exception loans from the same or different lenders.

1. Short-Term Ability-to-Repay (ST ATR) Loans

a. Upfront underwriting:

i. as described in Part III. above; and

ii. must determine whether the borrower has ATR while meeting expenses for 30 days following the end of the loan term.

iii. For a line of credit, must assume the line is fully utilized at consummation and that the consumer will make only the minimum payments. In addition, any advance more than 180 days after the previous determination requires a new ATR determination.

b. Loan flipping provisions, which apply across all lenders:

i. Prohibition against making an ATR loan while a ST exception loan is outstanding or within 30 days (mandatory cooling off period) following repayment of such loan.

ii. Presumptions of unaffordability in two general circumstances:

(1) For any second or third ATR loan made during, or within 30 days of repayment of, another covered ST loan or LTB loan. Exceptions where presumption does not apply:

(a) Total loan cost of the new loan is no more than 50% of total cost of the prior loan, which was repaid in full; or

(b) Rollover where borrower will not owe more on the new loan than paid on the prior loan, and new loan term is at least as long as the prior loan.

(2) Unaffordable outstanding covered loan, defined as:

(a) Delinquent by more than 7 days within the past 30 days;

(b) Consumer expresses within last 30 days an inability to make payment;

(c) New loan would result in effective skipped payment on old loan; or

(d) New loan proceeds not substantially more than one month's worth of payments on the old loan.

(3) Presumption may be rebutted by verified evidence (not merely borrower certification) of an improvement in borrower circumstances, versus the determination on the prior loan, sufficient to afford new loan.

iii. Prohibition for 30 days (mandatory cooling off period) after repayment of a third loan made within 30 days of a prior ST or LTB loan.

iv. These restrictions are enforced across lenders because all lenders must report loans to a registered information system.

CRL supports a front-end ability-to-repay requirement on every loan, including verification of income, major expenses, and borrowing history. CRL opposes cutting the cooling-off period (which helps to ensure that reborrowing is not triggered by the unaffordability of a balloon payment) from 60 days in the preliminary proposal to 30 days in the proposed rule. A cooling off period of at least 60 days is appropriate. As the Bureau's preliminary proposal notes, making a payment on the prior short-term loan could impact multiple cycles of household expenses. The 60-day period helps to allow the impact of the prior covered short-term loan on the consumer's finances to subside before the lender can extend another loan without verifying a change in circumstances.

CRL urges a 90-day limit per year on indebtedness in all ST loans, regardless of whether they are ATR loans or exception loans.

Full compliance with the rule will require centralized reporting, which is required by the rule. Many lenders already report to and consult with private commercial databases, and we support this requirement.

2. Short-Term (ST) Exception Loans

c. Outer limit of 6 ST exception loans and 90 days' total indebtedness in such loans in any 12-month period;

d. Limit of three loans in a sequence (where in a sequence means within 30 days of the prior loan) followed by a 30-day mandatory cooling off period;

e. First loan in a sequence cannot be larger than $500;

f. Requires proportional principal decrease over the three-loan sequence (e.g., loans of $450, $300, $150);

g. Loans must be fully amortizing;

h. No outstanding ATR ST loan or LTB loan from any lender;

i. Car title loans not eligible; and

j. Open-end loans not eligible.

CRL strongly opposes any exemptions from an ability-to-repay (ATR) requirement, as even a single unaffordable loan can cause substantial harm. CRL's research demonstrates that a very large portion of borrowers default on their first or second loans, providing further support that an ability-to-repay determination at the outset is required in order to prevent the harm caused by payday loans. Any default may result in lender-imposed late and non-sufficient fund fees, bank penalty fees, and abusive collection tactics, and cascading financial hardships.

An ATR requirement is particularly important for payday and car title loans, where the market incentive to underwrite is flipped on its head because the lender holds control over the borrower's checking account or access to the car title to coerce repayment. In this context, the lender is counting not on the borrower's ability to repay the loan, but rather on the lender's ability to collect on the loan, whether or not the borrower can afford to repay it.

Further, by sanctioning loans that rollover, which are evidence of inability to repay without reborrowing, and exempting six very high-cost loans annually from an ATR requirement, the Bureau would undermine the basic principle of requiring universal ATR, as well as existing state laws in about a third of states that do not permit such loans at all. While clearly not preemptive, the Bureau should not send the message that any loan made without a determination of the borrower's ability to repay is acceptable.

A 90-days' indebtedness limit is an important outer limit against prolonged indebtedness, consistent with the FDIC's 2005 guidelines addressing payday lending. But critically, it should be an outer limit, or a check, to ensure that ability-to-repay determinations at the outset are meaningful for <u>*all*</u> *short-term loans—not an option in lieu of determining front-end affordability. Thus, the 90-day limit should apply to both ATR and exception loans combined, not just exception loans.*

V. Longer-Term (LT) Loans

A. Scope

1. Longer than 45 days; <u>and</u>
2. Access to repayment from borrower's bank account or security interest in vehicle title taken within 72 hours of disbursement of proceeds; <u>and</u>
3. Over 36% all-in fee-inclusive APR, including interest, origination and add-on fees.
4. Exclusions include: credit cards, non-recourse pawn, secured purchase money auto loans, overdraft fees and overdraft lines of credit.

CRL supports an appropriately broad scope for longer-term loans as well as a carve-out for responsibly priced loans of an all-in fee-inclusive 36% APR or less.

Given deficiencies in the way the APR is often calculated, we strongly support the use of an "all-in" APR as the CFPB has proposed, which, like the APR under the Military Lending Act, includes fees and add-on *products. This all-in APR is critical to preventing evasion of coverage under the rule by charging periodic interest rates under 36% but outsized origination or other fees.*

We are concerned about the time limit of 72 hours to determine scope based on access to a leveraged payment mechanism. This should be broadened to include loans where the lender takes such access beyond three days.

We are also concerned about the exemption for credit cards. The rule relies on a definition of "credit card" in Regulation Z, which is very broad and could be easily evaded. In addition, some credit cards have very high rates and fees and are not sufficiently protected by the weaker ability to repay standard in the Credit CARD Act. The CFPB should exempt only credit cards that have an all-in APR of 36% or less plus only those fees permitted under the Military Lending Act regulations.

B. Rule: Lender may make long-term (LT) ATR loans and/or both of two types of LT exception loans in accordance with their respective requirements. One borrower could be made both ATR loans and both types of LT exception loans from the same or different lenders.

1. Long-Term ATR Loans

a. Upfront underwriting:

i. As described under general ATR requirements in Part III. above.

ii. The requirement differs from the Short-Term Ability-to-Repay (ST ATR) requirement in two key ways:

(a) Unless the loan has a balloon payment, there is no requirement that the lender determine the borrower can afford basic living expenses without reborrowing for 30 days beyond the loan term – only during the loan term itself.

(b) There is a requirement that the lender appropriately account for the possibility of volatility in borrower income and basic living expenses during the loan term, by establishing an amount of "cushion" in the ATR determination based on similarly situated borrowers.

iii. As noted earlier, for Long-Term Balloon (LTB) loans, the lender must determine the borrower will be able to meet basic living expenses for 30 days after the highest payment, as with ST ATR loan.

iv. For a <u>line of credit</u>, as with ST loans, must assume (1) the line is fully utilized at consummation; (2) only the minimum payments will be made; and (3) any advance more than 180 days after the previous determination requires a new ATR determination. In addition, if terms don't provide for an end-date to the line of credit, must assume the consumer must repay any remaining balance in one payment 180 days after consummation.

b. Loan flipping provisions:

i. Prohibition against making a LT ATR loan when ST exception loan from the same lender[1] is outstanding or within 30 days of repayment.

ii. Presumption of unaffordability in two general circumstances:

(a) ATR ST or LTB loan is outstanding, or within 30 days thereafter

(1) Exception: If every payment on new covered LT loan is substantially smaller than the largest payment on the prior loan.

(b) Unaffordable outstanding loan, whether covered loan or not, from the same lender, as determined by one of the following indicia of distress:

(1) significant delinquency, defined as more than 7 days within the last 30 days;

(2) borrower expresses an inability to make a payment within last 30 days;

(3) new loan would result in effective skipped payment on the existing loan; or

(4) new loan proceeds are not substantially more than one month's worth of payments on the old loan

(5) EXCEPTIONS:

(i) every payment on the new loan is substantially smaller than every payment the on outstanding loan; or

(ii) new loan would substantially reduce total cost of credit.

(c) Presumption may be rebutted by verified evidence (not merely borrower certification) of an improvement in borrower circumstances, versus the determination on the prior loan, sufficient to afford new loan.[2]

Again, CRL supports a required ability-to-repay determination but urges that the loopholes discussed in Part III. above – which are particularly concerning for longer-term loans – be closed. We also urge stronger protections against serial refinancings of LT loans than those proposed, as refinancings of covered loans are a strong indication that the borrower lacks the ability to repay. A refinance should carry a presumption of unaffordability if the borrower (1) is delinquent by even one day, or (2) if the borrower has not repaid 75% of loan principal. In addition, refinancing a covered loan a second time should be prohibited.

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[1] Any references to same lender include the lender's affiliates.

[2] If ST or LTB loan, then at time of that ATR determination. If not a ST or LTB loan, then during the last 30 days.

2. Long-term Exception Loans

a. There are two types of LT exception loans. This part a. lists the requirements unique to each type. At b. below, several parameters are listed which apply to both types of LT exception loans.

iii. Type 1: NCUA's "payday alternative loans" (PAL) program:

(a) $200-$1,000;

(b) Loan term from 46 days-6 months;

(c) Costs consistent with NCUA PAL program, currently max of 28% interest and application fee limit of $20; and

(d) Max of three loans outstanding from same lender during a 180-day period.

iv. Type 2: Default rate-based alternative:

(a) Portfolio default rate must remain at 5% or less, computed at least annually.[3] If default rate exceeds 5%, origination fee must be refunded for all loans included in the default calculation period;

(b) Fee-inclusive APR limit of 36%, with the exception of an origination fee that is either (a) $50 or less; or (b) a reasonable proportion of the lender's cost of underwriting; and

(c) Max of two loans outstanding from the same lender within 180 days.

b. The following apply to <u>both types</u> of LT exception loans:

i. Loan parameters: Must be closed-end, at least two payments, payments at least monthly, substantially equal payments due at substantially equal intervals, fully amortizing, no interest-only payments, no prepayment penalties.

ii. Upfront requirements:

(a) document proof of recurring income; and

(b) check lender/affiliate records (not other reporting systems) for the same type of outstanding LT exception loan.

iii. These loans are only permitted to the extent they are permitted under State laws.

iv. Restrictions on collection methods: Lenders that hold the borrower's deposit account, if loan becomes delinquent or default, cannot sweep account to negative balance to cover delinquency.

[3] Gross default rate, meaning unaffected by recoveries through collections following default or 120 days' delinquency, including loans on- and off-balance sheet.

v. Lenders must report the loan to either an information system or a national consumer reporting agency.

We oppose excluding from this rule's ability-to-repay requirement any loan with a fee-inclusive APR that exceeds the 36%, as both long-term alternative options do.

We also oppose sanctioning a substantial origination fee on every loan, as these options do.

In addition, we are concerned that lenders will use LT exception loans, for which no affordability assessment is required, as "gap" loans to bridge the waiting period between high-cost loans. This would permit the lender to keep the borrower as a continuous customer, making it easier for the lender to move borrowers back into more dangerous loans.

The preliminary SBREFA proposal included a different exemption, for high-cost loans where periodic payments did not exceed 5% of a borrower's monthly income. We support the removal of this exemption, as it disregarded a borrower's expenses and thus would not have ensured affordability or prevented harm. New CFPB data show that 40% of longer-term payday loans where payments do not exceed 5% of a borrower's monthly income still result in default.

VI. Payment collection practices

The proposed rule also includes protections around lender collection practices, summarized briefly here:

A. Required notice to consumers (at least three business days, and no more than seven business days) prior to attempting to collect payment from account; and

B. Limitation on attempts to collect payment from consumer's account to two failed consecutive attempts, at which point a new consumer authorization is required for that and future payments.

These proposed provisions underscore the tremendous harm that payday and car title lenders cause borrowers through first-in-line access to their checking accounts. We urge that these requirements be strengthened to require reauthorization for continued payments after three failed attempts in a 12-month period, even if those attempts are not consecutive.

VII. Enforcement

A. <u>Anti-evasion clause</u>: "A lender must not take any action with the intent of evading the requirements of this part."

B. <u>Both the Bureau and the state Attorneys General and state regulators have the authority to enforce the provisions</u>. This shared enforcement authority is provided in the Dodd-Frank Act, which recognizes the significant power of states to enforce against predatory lending practices.

We support a broad anti-evasion provision. We also continue to urge that CFPB offer states additional, and stronger, tools to effectively enforce their state laws by explicitly providing that offering, making, facilitating, or collecting a loan that violates a state usury or other consumer protection law is an unfair, deceptive, and abusive act or practice.

VIII. Additional Requirements

A. Reporting covered loan activity to "registered information systems," for which the proposal lays out a registration process

B. Compliance program, including written policies and procedures and record-keeping requirements

C. Effective date: Proposed as 15 months following publication of final rule.

IX. Comment period deadline

Comments on the proposed rule are due to CFPB by **October 7, 2016**.

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