Consumer Financial Protection Bureau

October 5, 2017

CFPB finalizes rule to stop payday debt traps

The Consumer Financial Protection Bureau (CFPB) today finalized a rule aimed at stopping payday debt traps by requiring lenders to determine upfront whether consumers have the ability to repay their loans. These strong, common-sense protections cover loans that require consumers to repay all or most of the debt at once, including payday loans, auto title loans, deposit advance products, and longer-term loans with balloon payments.

Background on payday, auto title, and balloon-payment loans

Payday loans are typically for small-dollar amounts and are due in full by the borrower's next paycheck, usually two or four weeks. They are expensive, with annual percentage rates of over 300 percent or even higher. As a condition of the loan, the borrower writes a post-dated check for the full balance, including fees, or allows the lender to electronically debit funds from their checking account. Single-payment auto title loans also have expensive charges and short terms usually of 30 days or less. But for these loans, borrowers are required to put up their car or truck title for collateral. Some lenders also offer longer-term loans of more than 45 days where the borrower makes a series of smaller payments before the remaining balance comes due. These longer-term loans – often referred to as balloon-payment loans – often require access to the borrower's bank account or auto title.

DEBT TRAP DANGERS

The Bureau has determined that risky lender practices are pushing borrowers into debt traps or forcing them to cede control of their financial decisions. Chief among these problems is that consumers are being set up to fail with loan payments that they are unable to repay. Faced with unaffordable payments, cash-strapped consumers must choose between defaulting, re-borrowing, or skipping other financial obligations like rent or basic living expenses such as buying food or obtaining medical care. The CFPB found that these practices can also lead to collateral damage to other aspects of consumers' lives such as vehicle seizure or steep penalty fees and bank account closures. Some of the dangers addressed in the final rule include:

- **Repeat short-term borrowing:** Re-borrowing occurs when a consumer pays new fees to extend the loan for a longer period of time, or takes out a subsequent loan soon after repayment, often the very same day. CFPB research shows that more than four out of five payday loans are re-borrowed within a month. As with payday loans, the CFPB found that the vast majority of auto title loans are re-borrowed on their due date or shortly thereafter. The majority of short-term loans are borrowed by consumers who take out a least 10 loans in a row, with the borrower paying far more in fees than they received in credit.
- **Default:** Default is the failure to repay a loan. After defaulting, some borrowers may become subject to aggressive and harmful debt collection efforts. One-in-five payday loan sequences and one-in-three single-payment auto title loan sequences end up in default, often after one or more instances of re-borrowing. When the Bureau compared longer-term loans with and without a balloon payment made by the same lender, it found that the balloon-payment loans were much more likely to end in default.
- **Auto Seizure**: Auto title loan borrowers who cannot repay the initial loan must re-borrow 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 out of five single-payment auto title loan sequences ends up having their car or truck seized by the lender for failure to repay.
- **Penalty Fees**: Attempts by lenders to debit payments from a consumer's checking account can add a steep, hidden cost to payday loans. CFPB research found that, over a period of 18 months, half of payday and payday-installment 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 payday lender ended up being closed by the depository institution. This happened usually within 90 days of the first insufficient funds transaction.

Rule to stop debt traps

The CFPB rule aims to stop debt traps by putting in place strong ability-to repay protections. These protections apply to loans that require consumers to repay all or most of the debt at once. Under the new rule, lenders must conduct a "full-payment test" to determine upfront that borrowers can afford to repay their loans without re-borrowing. For certain short-term loans, lenders can skip the full-payment test if they offer a "principal-payoff option" that allows borrowers to pay off the debt more gradually. The rule requires lenders to use credit reporting systems registered with the Bureau to report and obtain information on certain loans covered by the proposal. The rule allows less risky loan options, including certain loans typically offered by community banks and credit unions, to forgo the full-payment test. The new rule also includes a "debit attempt cutoff" for any short-term loan, balloon-payment loan, or longer-term loan with account access and an annual percentage rate higher than 36 percent that includes authorization for the lender to access the borrower's checking or prepaid account. These protections are in addition to existing requirements under state or tribal law.

FULL-PAYMENT TEST

Under the full-payment test, lenders are required to make an upfront determination of a consumer's ability to repay the loan. The full-payment test includes:

- **Requirements for determining affordability:** Lenders are required to determine whether the borrower can pay the loan payments and still meet basic living expenses and major financial obligations both during the loan and for 30 days after the highest payment on the loan. For payday and auto title loans that are due in one lump sum, full payment means being able to afford the total loan amount, plus fees and finance charges within two weeks or a month. For longer-term loans with a balloon payment, full payment means being able to afford the payments in the month with the highest total payments on the loan. To support the full-payment test, the lender must verify income and major financial obligations and estimate basic living expenses for a one-month period—the month in which the highest sum of payments is due. The rule also caps the number of short-term loans that can be made in quick succession at three. In determining ability to repay, lenders can reasonably rely on borrowers' stated income if further verification evidence is unavailable and can reasonably rely on borrower's stated rental housing expenses before making a loan.
    - **Payday and single-payment auto title loans***:* For short-term loans, lenders are required to determine that the borrower has sufficient income to pay the loan 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. Lenders also can take into account income of a household member if the borrower has verified access to that income, and shared payment of major financial obligations and basic living expenses.

    - **Longer-term balloon-payment loans***:* For longer-term loans with a balloon payment, lenders are 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 making payments during the month with the loan's highest payment.

- **Cooling-off period:** Lenders must respect a mandatory 30 day cooling-off period after the third covered short-term or longer-term balloon-payment loan in quick succession.

PRINCIPAL-PAYOFF OPTION FOR CERTAIN SHORT-TERM LOANS

Consumers may take out a short-term loan of up to $500 without the full-payment test if it is structured to allow the borrower to get out of debt more gradually. Under this principal-payoff option, a consumer can either repay the loan in a single payment or have up to two subsequent loans where the principal is steadily paid down. 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 cannot take an auto title as collateral or structure the loan as open-end credit. Lenders also cannot offer the option to consumers who have recent or outstanding short-term or balloon-payment loans. Further, lenders cannot make more than three such loans in quick succession, and they cannot make loans under this option if the consumer has already had more than six short-term loans or been in debt for more than 90 days on short-term loans over 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 additional loans, but only if the borrower pays off at least one-third of the original principal with each extension. This 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 rule requires 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.

LESS RISKY LOAN OPTIONS

Loans that pose less risk to consumers do not require the full-payment test or the principal-payoff option. This includes loans made by a lender who makes 2,500 or fewer covered short-term or balloon-payment loans per year and derives no more than 10 percent of its revenue from such loans. These are usually small personal loans made by community banks or credit unions to existing customers or members. In addition, the rule does not cover loans that generally meet the parameters of "payday alternative loans" authorized by the National Credit Union Administration. These are low-cost loans which cannot have a balloon payment with strict limitations on the number of loans that can be made over six months. The rule also excludes from coverage certain no-cost advances and advances of earned wages made under a wage advance program. Under such a program, the employer could deduct the amount already earned and advanced from the employee's next paycheck, or the employer's business partner could debit the amount from the employee's bank account on the employee's next payday. No other collection mechanisms would be allowed.

REPORTING REQUIREMENTS

The rule requires lenders to use credit reporting systems registered by the Bureau to report and obtain information about loans made under the full-payment test or the principal payoff option. Companies can apply for and will be designated as "registered information systems" by the Bureau. As consumer reporting companies, the registered information systems are subject to applicable federal laws. Lenders are required to report basic loan information and updates to that information. If no registered information systems are available, then lenders can make loans under the full-payment test without obtaining a report from an information system but they must still check their own records. Principal-payoff loans, however, could not be made if no registered information systems are available.

PENALTY-FEE PREVENTION

Repeated unsuccessful withdrawal attempts by lenders to collect payment from consumers' accounts can pile on insufficient funds fees for consumers from their financial institution and prompt returned payment fees from the lender. These attempts can also lead to bank account closures. To protect consumers, the rule includes penalty-fee prevention measures that apply to short-term loans, balloon-payment loans, and any loan with an annual percentage rate over 36 percent that includes authorization for the lender to access the borrower's checking or prepaid account. These protections will give consumers a chance to dispute any unauthorized or erroneous debit attempts, and to arrange to cover unanticipated payments that are due. This should mean fewer consumers being debited for payments they did not authorize or anticipate, or charged multiplying fees for returned payments and insufficient funds. Specific payment protections include:

- **Written notice**: Lenders have to give consumers written notice before the first attempt to debit the consumer's account to collect payment for any loan covered by the rule. This notice alerts consumers to the timing, amount, and channel of the forthcoming payment transfer. If a subsequent payment transfer is 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 lender must give a notice specifically alerting the consumer to the change.
- **Debit attempt cutoff**: After two straight unsuccessful attempts, the lender is 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 penalty-fee prevention measures will not apply to banks or credit unions that make loans to their own customers if those loans cannot generate overdraft or insufficient funds fees.

LOANS COVERED UNDER THE RULE

The ability-to-repay protections apply to loans that require consumers to repay all or most of the debt at once, including payday loans, auto title loans, deposit advance products, and longer-term loans with balloon payments. The penalty-fee prevention measures apply to a broader swath of the market, covering short-term loans, balloon-payment loans, and any loan with an annual percentage rate over 36 percent that gives the lender account access. The final rule does not apply ability-to-repay protections to all of the longer-term loans that would have been covered under the proposal. The CFPB is conducting further study to consider how the market for longer-term loans is evolving and the best ways to address concerns about existing and potential practices.

All lenders who regularly extend credit are subject to the CFPB's requirements for any loan they make that's covered by the rule. This includes banks, credit unions, nonbanks, and their service providers. Lenders are required to comply regardless of whether they operate online or out of storefronts and regardless of the types of state licenses they may hold.

###

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.