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October 7, 2016

Director Richard Cordray
c/o Monica Jackson, Office of the Executive Secretary
Consumer Financial Protection Bureau
1700 G St. NW
Washington, DC 20552
Via Electronic Submission

RE: Payday, Vehicle Title, and Certain High-Cost Loans (Proposed Rule);
Docket No. CFPB-2016-0025 (RIN 3170-AA40)

Director Cordray:

The following letter summarizes comments from The Pew Charitable Trusts regarding the Bureau's pending small-dollar loan rule. Based on extensive research conducted over more than five years, Pew strongly supports efforts to reform the market for payday and similar loans. This is because of the harm consumers endure and because experience has shown that improved regulatory structures can promote access to useful small-dollar credit while dramatically improving outcomes for consumers.

Pew is supportive of the Bureau's efforts to give borrowers more time to repay loans and protect them from harmful practices such as repeated electronic debits against their checking accounts. However, as explained below, Pew is deeply concerned that the Bureau's rule as proposed would fail consumers and the public interest in two key ways: One, it would make it far too easy for unscrupulous lenders to continue to make harmful and unnecessarily costly loans; and two, it would miss an opportunity to provide clear yet firm regulatory guidelines that would enable lower-cost lenders to provide safe and competitive alternatives that could save millions of borrowers billions of dollars per year compared to the high-cost credit that will remain widely available under the CFPB's proposed rule.

We respectfully urge the Bureau to make several important adjustments to the proposed rule, both to make it harder for unscrupulous lenders to abuse post-dated checks and other "leveraged payment mechanisms," and to provide a streamlined compliance option that simultaneously provides stronger protections for consumers and clearer rules that make compliance easier and less costly for more scrupulous installment lenders. Not only would these changes be good for consumers, the general public, and the market as a whole but they would also substantially improve the Bureau's legal justification for imposing this rule.

Despite our misgivings about the rule as proposed, we are confident that with key adjustments it can achieve its potential to help millions of struggling consumers and endure despite the legal challenges of those who oppose reform. On behalf of myself, the full-time staff of Pew's small-dollar loans project, and our many colleagues who have worked on this issue over the years, I thank you for considering our recommendations. It has been a pleasure working with the Bureau on this very challenging policy issue and we look forward to continuing to work together in pursuit of consumer protection and fair, competitive, and transparent consumer finance markets in the years ahead.

Sincerely,

Nick Bourke
Director, Consumer Finance
The Pew Charitable Trusts
www.pewtrusts.org/small-loans

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1. Pew's Qualifications for Commenting on the Rule

The Pew Charitable Trusts is a global, non-governmental research and public policy organization dedicated to serving the public. We strive to improve public policy by conducting rigorous analysis, linking diverse interests to pursue common cause, and focusing on tangible results. Consumer finance is an area to which Pew has dedicated significant resources in recent years.

Specifically, Pew's board of directors approved and funded the small-dollar loans project in December of 2010, five months after Congress authorized the creation of the CFPB as part of the Dodd-Frank Act. Pew's small-dollar loans project works to provide thorough, objective analysis to help inform the efforts of policy makers including the CFPB. In creating the small-dollar loans project in 2010, we realized that there were significant gaps in available research about the market for payday, auto title, and similar forms of small-dollar loans, particularly with respect to understanding the needs and experiences of borrowers and identifying and evaluating policy responses to perceived consumer harms.

Now, more than half a decade later, Pew's small-dollar loans project has produced a comprehensive body of research and developed a group of highly qualified experts on this subject. The team's director has been with the project since its inception in 2010, and the two lead researchers have been with the project for more than five years each. Altogether, the full-time staff on this project collectively has more than twenty years of experience working together to conduct research and analysis on the market for payday and similar small-dollar loans. Their prior training and experience includes advanced degrees in law and public policy (including training in statistical research methods), professional public opinion research at the highest levels, product management and consulting work in the consumer finance industry and elsewhere, Wall Street analyst experience, community organizing, and policy analysis and advocacy.

In July of 2012, we published our first report, entitled "Payday Lending in America: Who Borrows, Where They Borrow, and Why." This report included findings from a first-ever nationally representative telephone poll of payday loan borrowers about their experiences using the loans.[1] The *Payday Lending in America* series of reports grew over the following three years to include a total of five reports about payday lending, online payday lending, and auto title lending—essentially, what the Bureau's draft rule refers to as "covered loans."[2]

As of this writing, Pew's research and contributions to the literature include the following:

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[1] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf. Methodology for the report is available at page 31.

[2] The reports are attached in Appendices J-N, and are also available as a collection online at http://www.pewtrusts.org/en/research-and-analysis/collections/2014/12/payday-lending-in-america.

- Unique, nationally representative surveys consisting of in-depth telephone interviews with borrowers of payday and similar loans (as well as the general public) conducted according to the highest standards of survey research.

- Conversations with hundreds of borrowers in more than 20 focus groups throughout the country.

- Scores of meetings, interviews, and store visits with lenders and consumer finance professionals of all types. Most recently, Pew completed one-on-one interviews with dozens of bank and credit union officials and convened a group of executives from more than ten banks (which collectively operate approximately one-fifth of all bank branches in the United States) to discuss the proposed rule.

- Extensive consultation with community groups in a majority of states, including representatives of consumer advocacy groups, civil rights and faith-based organizations, consumer credit counselors, legal advocates, and others.

- Analysis of academic literature and regulatory data. We have read all published academic papers about payday and auto title loans and reviewed all publicly available data about this market from state and federal government agencies as well as additional non-publicly available data obtained through special requests to various regulators and private companies.

- Including the five *Payday Lending in America* reports, Pew's small-dollar loans project has released more than 20 carefully researched and reviewed issue briefs, fact sheets, and multi-media publications. See Table 1 at the end of this section for a selected list with links to our website (www.pewtrusts.org/small-loans); many of these publications are also attached in Appendices J through AB).

- In recent years, we have submitted comment letters, testimony, technical assistance, and informal input to federal regulators and state government officials throughout the country and spoken about this topic at dozens of conferences and other professional gatherings. Our work has been cited or quoted in a wide variety of publications from federal, state, and local government officials including the Bureau.

Pew spent nearly three years researching the markets for payday and similar forms of small-dollar credit before developing initial policy recommendations, in October of 2013.[3] The report included a case study of Colorado's 2010 payday loan reform law (which converted payday loans in that state

[3] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.

from conventional short-term loans to those that last about six months); survey data finding that borrowers favor having more time to repay loans in smaller installment payments; and discussion of various potential benefits and harms associated with installment lending and how policy could help ensure that the migration to installment lending is safe and effective.[4] In the years since, we have revisited the data underlying that report and supplemented our recommendations with additional research and analysis, making revisions where appropriate.

Pew is deeply committed to unbiased research and dedicated to improving public policy through pragmatic measures that would accommodate legitimate interests of both borrowers and lenders, as well as the public generally. Stakeholder outreach has been a constant feature of our work since it started.

In sum, Pew is highly qualified to comment about the proposed rule for payday, vehicle title, and certain high-cost installment loans. We are honored that the Bureau's Notice of Proposed Rulemaking cited our work more than 40 times, and though we are critical of certain aspects of the CFPB's proposal, we hope the Bureau finds value in our input. We look forward to the opportunity to work with the Bureau as it modifies and finalizes this important rule.

[4] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.

Table 1: Selected Publications from Pew's Small-Dollar Loans Project
Report 1 - Payday Lending in America series: Who Borrows, Where They Borrow, and Why
Report 2 - Payday Lending in America series: How Borrowers Choose and Repay Payday Loans
Report 3 - Payday Lending in America series: Policy Solutions
Report 4 - Payday Lending in America series: Fraud and Abuse Online: Harmful Practices in Internet Payday Lending
Report 5 - Payday Lending in America series: Auto Title Loans: Market Practices and Borrowers' Experiences
Fact Sheet: How State Rate Limits Affect Payday Loan Prices
Interactive: State Payday Loan Regulation and Usage Rates
Issue Brief: Trial, Error, and Success in Colorado's Payday Lending Reforms
Issue Brief: Understanding the CFPB Proposal for Payday and Other Small Loans
Issue Brief: CFPB Proposal for Payday and Other Small Loans: A Survey of Americans
Issue Brief: From Payday to Small Installment Loans
Fact Sheet: Payday Loan Facts and the CFPB's Impact
Analysis: Reforming Payday Loans Begins With Understanding How They Really Work
Analysis: How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans
Analysis: How the CFPB Proposal Would Regulate Payday and Other Small Loans
Analysis: The CFPB's Proposed Payday Loan Regulations Would Leave Consumers Vulnerable
Video: Payday Loans Explained
Video: Payday Loans: Who Uses Them and Why?
Video: Payday Loans—And How to Fix Them

2. Executive Summary

Millions of the most financially fragile individuals in this country are experiencing harm because payday loans and other small-dollar loans that they seek to get help paying bills actually have the reverse effect of making it harder to make ends meet. This problem is compounded as lenders find new ways to abuse "leveraged payment mechanisms" to collect on loans even when it undermines borrowers' ability to meet basic needs or other financial obligations. As summarized in Section 3 of this letter, the case for reform is overwhelmingly supported by research.

After more than half a decade of relevant research and analysis, we have concluded that credit can in fact help people cope with periodic shortfalls in their monthly budgets, but *only if that credit is structured a certain way*. In the case of covered loans (like payday and auto title loans) any regulatory reform must come as close as possible to ensuring that several conditions are met. Pew published its original recommendations elaborating this concept in October of 2013, and they are summarized as follows:

- Limit payments to an affordable percentage of a borrower's periodic income.
- Spread costs evenly over the life of the loan.
- Guard against harmful repayment or collection practices and excessively long loan terms.
- Require concise disclosures that reveal both periodic and total costs.
- States should continue to set maximum allowable charges on loans for those with poor credit.[5]

It is not surprising that the Bureau has not set maximum allowable charges because it lacks such general authority. But the Bureau can and should do more to meet the other goals expressed above. While the proposed rule would change the market by generally requiring lenders to provide more time to repay loans, it falls short in several respects.[6]

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[5] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf.

[6] Usury laws have existed for millennia, and legal price limitations on consumer credit play an undeniable role in our country's legal system. The fact that the Bureau lacks the absolute power to regulate prices on covered loans leaves state lawmakers (who do have this power with respect to state-licensed lenders) with an important role to play in ensuring consumer protection and fair, competitive markets. But it does not mean that the Bureau cannot make significant contributions to these efforts. Indeed, if the Bureau adjusts its rule to address the other factors noted above according to the recommendations provided in this letter, it can radically improve the market for covered loans despite the fact that it lacks the power to regulate rates or finance charges generally. See Id. at 39-40; see also The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf.

More specifically, the Bureau has relied too heavily on underwriting to solve the deep problems in this market. We have come to understand that underwriting—specifically, the process for evaluating an applicant's ability to repay a loan according to its terms—plays an important role in meeting the objectives listed above, but it is not sufficient by itself. In the market for covered loans, where lenders have leveraged payment mechanisms allowing them to reach into financially fragile borrowers' checking accounts or repossess vehicles to ensure their "ability to collect," underwriting alone cannot solve the problem or ensure better consumer outcomes. Instead, the Bureau must establish more direct ways of ensuring affordable monthly payments, reasonable time to repay a loan, protection against large up-front fees, and other factors within the Bureau's jurisdiction.

As explained in Section 4 of this letter, we recognize that the CFPB rule will not put an end to high-cost lending. Rather, high-cost lending will continue to exist in most states, and is even likely to thrive. Payday and auto title lenders have already started adapting to the pending rule by becoming makers of longer-term loans; in fact, our research shows that these lenders are already making high-cost installment loans and lines of credit in a majority of states and are likely to expand to others.[7] This is not necessarily a problem in and of itself.[8] What is problematic is that these loans are likely to continue to be characterized by unaffordable payments and other abusive practices. We have concluded, along with most industry experts who have spoken with us or published on this issue, that a majority of today's payday loan borrowers will continue to be approved for high-cost payday installment loans or lines of credit even under the rule. Further, based on its commentary in the proposed rule, the CFPB seems to agree with industry analysts that millions of payday and auto title loan applicants will pass the ability-to-repay test for loans requiring payments of $200 or more per month—even though this is *far higher* than what most borrowers say they can afford (indeed, extensive research shows that loan payments above about $125 would not be affordable for most of today's borrowers; see Section 3(f)(i) of this letter for discussion and Appendix C).

The CFPB's proposed rule does not adequately address the core harms presented by the leveraged payment mechanism. As we discuss in Section 5 of this letter, the leveraged payment mechanism is a powerful tool that enables lenders to make small loans to financially struggling borrowers even as it inherently puts borrowers at risk of harm, and only strong regulatory guidance can put these forces in balance. Yet by focusing almost exclusively on the process that lenders follow to originate loans, the rule would give lenders far too much leeway to justify unaffordable loan payments and

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[7] The Pew Charitable Trusts, *From Payday to Small Installment Loans* (2016), 5, http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf#page=5. We have seen payday and auto title lenders make high-cost installment loans and lines of credit in 28 of the 41 states in which they operate. The cited brief states that such loans are available in 26 of the 39 states where payday and auto title lenders have stores today; yet we recently discovered that lenders have begun offering high-cost payday installment loans in Arkansas and high-cost lines of credit in Maryland (two previously restrictive states where such high-cost loans did not exist). See Section 4(a) of this letter for discussion.

[8] Our research has shown that liquidity credit can be helpful, even at high cost, but only if it is structured in a way to ensure affordable payments, reasonable time to repay, and the other safeguards noted above.

other unreasonable terms by using aggregate data to estimate an applicant's financial condition,[9] and it gives regulatory examiners few tools for detecting or proving when a lender has not made a "reasonable determination" as required by the proposal. This means that if the proposed rule produces a net benefit to consumers, it is likely to be quite modest.

In short, our research indicates that millions of people will continue to be exposed to expensive and often harmful loans even under the proposed rule. That is why, in Section 6, we propose several modifications to the longer-term ability-to-repay section that would put limits, for example, on how long a lender may hold a leveraged payment mechanism or how much of a person's monthly paycheck a lender may withdraw from a borrower's bank account—and generally, to make it harder for unscrupulous lenders to abuse leveraged payment mechanisms.

But as important as it is for the Bureau to make it harder for abusive lenders to originate harmful loans, consumers and the public have far more to gain if the Bureau adjusts its rule to facilitate the growth of better small-loan alternatives from mainstream lenders. Pew has published extensively on this topic and we continue to call on the Bureau to create a streamlined compliance option establishing very clear guidelines for how loans should be structured. Such clarity is currently missing in federal law, and that is why lower-cost lenders such as banks and credit unions that could otherwise be providing alternatives at wide scale have tended to avoid this market. At the same time, creating a compliance option based on very clear rules would provide better protection to consumers by firmly limiting the size of monthly payments and otherwise ensuring that loan products are of good quality.[10]

We recognize that there are millions of consumers who value having access to small-dollar credit, but desperately want and deserve relief from harmful practices and unnecessarily high costs, and who could save billions of dollars per year if mainstream lenders began offering safer, lower-cost small-loan alternatives at scale. The possibilities of better loan alternatives made according to clear consumer protection guidelines are especially strong in the case of banks and credit unions, where 12 million payday loan borrowers already have checking accounts (because it is required to obtain the loan) and lenders could, if provided with clearer regulatory guidance, profitably offer loans at prices that are at least six times lower than what payday lenders charge.

[9] For example, as discussed in Section 5(e) of this letter, the Bureau seems to expect that under the ability-to-repay test a lender could make a loan to a typical payday loan borrower and justify monthly payments calculated as "remaining income" of anywhere between $218 and $1,611 (or, using averages, $689) minus formal debt obligations and "other living expenses" (which are not defined but do not include housing, transportation, utilities, and food because they are already accounted for in the "remaining income" tally).

[10] Lenders would, of course, develop underwriting policies for these loans, and CFPB examiners would be able to enforce remedial measures against lenders that do not create adequate underwriting policies or that experience unacceptably high default rates (this would be similar in practice to how the CFPB would expect to determine whether lenders are making a "reasonable determination" under the core "ability-to-repay" rule, but the difference here would be that lenders would also be following strict rules limiting monthly payments to 5 percent of borrower income and other product safety guidelines). Further, any *depository lender* using the 5 percent payment option would need to assure its prudential regulators that it has designed an appropriate loan underwriting and origination model, to ensure for example that the bank or credit union is only lending to customers with accounts in good standing and is not taking on unreasonable credit risk.

As proposed, the CFPB rule falls far short of seizing this pivotal opportunity.[11] That is why Pew's strongest recommendation to the Bureau is to restore the "5 percent payment-to-income ratio alternative" in its final rule, with certain adjustments.[12] If the CFPB were to leave the 5 percent payment-to-income ratio alternative out of the final rule, it would be removing the one element of the Bureau's entire proposal that is likely to save millions of low- and moderate-income households more than $10 billion per year.

The 5 percent payment-to-income ratio alternative is an idea that is backed by extensive research and is also popular with borrowers, the public, credit counselors, various community groups and consumer advocates, banks, credit unions, and some lower-cost non-bank lenders. For example, in its proposal the Bureau noted that more than 30 credit unions and several banks expressed support for the 5 percent payment-to-income ratio alternative when the Bureau initially proposed it in 2015, and we are aware that a variety of other lenders and other stakeholders have indicated support to the Bureau since then. Results from Pew's latest survey work, summarized in Sections 3(d) and 3(e) of this letter, show strong ongoing support from borrowers and the public. For examples of other support, see Appendices G, H, and I.

The Bureau also noted that some stakeholders have raised concerns about the 5 percent payment-to-income ratio alternative. We propose, in Section 6, several adjustments that should alleviate these concerns. These include allowing loans to last longer than six months in certain cases where lenders limit the loans' costs (to respond to concerns from SBREFA panelists and other commentators that such loans would be too small or that some borrowers would benefit from having more time to repay) and restricting lenders from using the 5 percent payment option if they experience high default rates (to respond to concerns that even with loan payments firmly limited to 5 percent of a borrower's paycheck, some consumers would be unable to afford such loans; a default rate threshold helps ensure that lenders use careful underwriting practices and make reasonable efforts to screen out applicants who are unable to afford to borrow).[13] The CFPB should also clarify that a 5 percent payment option would not be an income-only approach to lending because lenders would be expected to use their own underwriting methods to screen out applicants who are not likely to benefit from credit.[14]

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[11] As explained in Sections 4 and 6 of this letter, the Bureau's proposed longer-term conditional exemptions would not be suitable for loan programs that could achieve the volume needed to outcompete payday lenders. They might help preserve some low-volume, ad hoc "character lending" programs of the type that exist at a minority of small banks and credit unions today. However, the proposed "portfolio default rate" option is a dangerous and inefficient means of meeting this goal, and the Bureau should replace it with a much simpler volume-based option.

[12] The Bureau specifically requested comments about the 5 percent payment-to-income ratio alternative. 81 F.R. 48040.

[13] The proposal's commentary also noted that the Bureau's research shows a correlation between payment-to-income ratio and levels of default, but found that in its own data there was not a clear "inflection point" supporting any exact payment-to-income ratio number. As we explain in this letter (and summarize in Appendix C), there is overwhelming external research supporting 5 percent as an appropriate benchmark.

[14] We also note that the 5 percent payment option would firmly shield 95 percent of a borrower's income from being used to repay covered loans regardless of the underwriting approach used, something no other part of the proposed rule would do.

These modifications address the substantive concerns raised while preserving the fundamental value of the 5 percent payment option. Based on our extensive outreach to lenders (particularly banks and credit unions) and our own thorough modeling, we are confident that lenders could profitably offer loans under the 5 percent payment option with terms that are far superior to conventional payday loans and which the vast majority of the public (and borrowers themselves) view as fair. This would provide tremendous benefit to consumers and the market generally.

The primary opposition to the 5 percent payment option has come from payday lenders who are seeking to maintain a *de facto* monopoly on the small-dollar loan market by preventing banks and credit unions from offering lower-cost credit at scale. Others have opposed this option as a continuation of the "payday loans vs. no loans" debate of prior decades, employing a strategy of imposing procedural hurdles to making loans in the hope that this leads to the elimination of most small credit. However, borrowers themselves strongly support the loans that would arise from the 5 percent payment option, and it is clear that they would save billions of dollars annually compared with longer-term ability-to-repay loans.[15]

We hope the Bureau recognizes that the 5 percent payment option, like most beneficial public policies, produces diffuse benefits yet concentrated costs, explaining the narrow-but-vocal opposition to it based on ideology or self-interest, even though it is strongly welfare-enhancing and widely popular. Adjusting the rule accordingly would help provide millions of borrowers what they want and need: access to better small loans, with predictably affordable monthly payments, reasonable time to repay, much lower costs, and protections against hidden fees. The 5 percent payment-to-income ratio alternative is an essential component in achieving this goal.

It is important to note that there are some beneficial aspects to the Bureau's proposed rule. It will substantially curtail the single-payment loan market, shifting most lending to installment loans and lines of credit. This is a necessary element of successful reform. The proposal also had two improvements with respect to the short-term alternative the Bureau originally proposed by requiring a three-loan sequence to amortize and by adding a cooling-off period between short-term alternative and longer-term ability-to-repay loans, preventing lenders from using the short-term alternative as a way to steer customers into the more profitable longer-term ability-to-repay loans. The Bureau has also required lenders to account for income and expense volatility for longer-term loans to better reflect borrowers' financial fragility. The Bureau's requirement that lenders must receive new permission to debit a borrower's account if two consecutive withdrawals fail is also an important protection. If the final rule includes other key improvements to go along with these components, it would measurably improve the lives of millions of Americans.

[15] Pew has stated many times that policy makers, such as state legislators, may choose to respond to the harms of payday lending by enacting low usury rate caps that eliminate high-cost lending, or by thoroughly reforming the high-cost loan industry with clear rules of the type discussed above. The CFPB is, by definition, pursuing the latter approach and high-cost lending will absolutely continue under this rule. For borrower opinions, see Section 3(d) of this letter.

Finally, we conclude this executive summary with a note about the Bureau's legal authority. In our view, there is no doubt that consumers are experiencing harm in this market, and regulatory action from the CFPB is justified. Given our experience as researchers and analysts in this market, our letter will focus on providing substantive commentary to the Bureau without addressing the CFPB's legal authority except in specific circumstances. However, it is worth noting that we are concerned that the Bureau has left itself unnecessarily exposed to legal challenges from those who oppose regulation because even though the costs it would impose on lenders are manageable, the benefit of the rule-as-proposed is tenuous. The recommendations included in this letter would, we believe, strengthen the Bureau's position by tailoring the rule to redress harms associated with leveraged payment mechanisms more directly, and by providing a streamlined compliance option for longer-term loans that simultaneously provides better benefit for consumers and a simplified, lower-cost compliance option for lenders.[16]

[16] This is another reason that Pew supports adding the 5 percent payment-to-income ratio alternative to the final rule. The Bureau has taken the position that it has the legal authority to mandate that all lenders make a choice between complying with the general ability-to-repay rule or following any of a number of alternative compliance approaches ("conditional exemptions") which require the lender to abide by a set of relatively more prescriptive rules in exchange for being relieved from the core ability-to-repay procedural mandate. Pew believes that the 5 percent payment-to-income ratio option fits easily within this framework and the CFPB has clear authority to include it in the rule. To the extent that the Bureau would need to justify the specific rules associated with the 5 percent payment option, we note that it is supported by extensive research showing that this option would generate routinely affordable monthly loan payments, better consumer outcomes, and access to credit. See Section 6 of this letter for discussion and Pew's extensive publications on this topic. As a practical matter, Pew would support applying the rules found in the 5 percent payment option to *all* covered loans because that would greatly simplify the rule and the regulatory examination process, while ensuring a higher quality of loan overall and allowing for innovation in how loans are underwritten and originated. But the Bureau has not proposed to do that and we presume that the Bureau believes it would not have the authority to do so or does not wish to do so for other reasons.

3. Conclusions Based on Research Findings

(a) Borrower profile

Individuals who use high-cost payday loans are struggling financially, and 58 percent report trouble covering ordinary living expenses from month to month.[17] A majority (52 percent) report paying bank overdraft fees, and most carry credit cards but with little available credit.[18] Almost all have a damaged credit history that makes them ineligible for mainstream consumer credit, with credit scores that are at the lowest end of the scale (typical FICO scores in the low 500s[19] and similarly low VantageScores in the mid-to-high 500s[20]). These consumers are not the unbanked–they have an income and checking account, which are requirements for getting a payday loan–but they are dealing with periodic cash shortfalls rather than rare and unexpected emergency expenses.[21]

The average payday loan borrower earns about $30,000 per year,[22] although borrowers within every income group have used a payday loan.[23] Regardless of income, most borrowers find it difficult to repay the average lump-sum payment of $430 that is required on their next payday, which represents 36 percent of the average borrower's paycheck. Only 14 percent of borrowers say they can actually afford this amount.[24]

Instead, the average payday loan borrower can afford to pay $50 per two weeks (or $100 per month)—similar to the fee for renewing a typical payday loan today. These data help explain why most borrowers renew or reborrow rather than repay their loans in full, and why the CFPB has found that 82 percent of loans are renewals or quick reborrows[25] while lenders report that loan loss rates are only 3 percent.[26]

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[17] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 10, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=10.

[18] Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, 13, http://dx.doi.org/10.2139/ssrn.2160947. Fifty-nine percent of borrowers in the dataset have a credit card.

[19] Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, http://dx.doi.org/10.2139/ssrn.2160947.

[20] Jennifer Priestley, *Payday Loan Rollovers and Consumer Welfare*, Table 5, 2014, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2534628.

[21] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2013), 14, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=16.

[22] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 53, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=59

[23] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 10, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=12.

[24] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 14, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=14.

[25] Consumer Financial Protection Bureau, *CFPB Data Point: Payday Lending* (2014), 9, http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf#page=9.

[26] Advance America, Cash Advance Centers Inc., *Form 10-K Annual Report* (Period Ending 12/31/11), 5 and 41, http://quote.morningstar.com/stock-filing/Annual-

Auto title loans are a similar form of high-cost lending and mirror payday loans in both structure and borrower experience. These borrowers are also unable to qualify for traditional financing, and they struggle to make ends meet. Three-quarters of auto title loan borrowers report having a checking account,[27] though they do not necessarily need an income to obtain the loan, as the lender can repossess the borrower's vehicle if they fail to repay. Further, loan payments are even larger and consume half of the average borrower's monthly income.

Borrowers are not shopping for credit in the conventional sense, but rather trying to cover regular recurring expenses: 69 percent of first-time payday borrowers used the loan to cover a recurring expense, such as utilities, credit card bills, rent or mortgage payments, or food, while 16 percent dealt with an unexpected expense, such as a car repair or emergency medical expense.[28] Yet research has found that use of payday loans has a negative effect on the ability of lower-income households to meet other expenses.[29] Borrowers are torn about the experience–a majority says payday loans take advantage of them, and a majority also says they provide relief. The appreciation for urgently needed cash and friendly service conflicts with borrowers' feelings of dismay about high costs and frustration with unaffordable payments and lengthy indebtedness.[30]

Repaying the loan in one lump sum is difficult for most borrowers. Previous research, as well as discussions with industry leaders, and state-level reports, all make clear that a typical borrower uses payday loans many times per year, and much of this borrowing comes in relatively quick succession once someone begins using payday loans.[31] To repay a loan, 41 percent have needed

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Report/2011/12/31/t.aspx?t=XNYS:AEA&ft=&d=c12cd1f791e34bf03980d4825adc1730. Using 2011's Annual (10-K) Report from Advance America, the largest storefront lender, as an example, we can calculate an approximate loss rate by dividing the "provision for doubtful accounts" by the "aggregate principal amount of cash advances originated." This calculation of $107,911,000 divided by $3,965,225,000 yields an estimated loss rate of 2.72 percent. Borrowers may renew or reborrow a loan, or experience temporary defaults by bouncing checks and incurring nonsufficient funds fees while still paying back a loan eventually; Jamie Fulmer, "Advance America and Payday Lending: Who Borrows and Why," *Advance America*, presentation, Oct. 18, 2012, http://www.ncsl.org/portals/1/documents/fiscal/Jamie_Fulmer_PowerPoint.pdf#page=12. Advance America has made a similar point, stating, "97 percent of our customers pay us back;" David Burtzlaff and Brittny Groce, *Payday Loan Industry*, Stephens Inc. (2011).

[27] The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences* (2015), 7, http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf#page=11.

[28] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2013), 14, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=16.

[29] Brian T. Melzer, *The Real Costs of Credit Access: Evidence from the Payday Lending Market*, The Quarterly Journal of Economics (2011) 126: 517-555, http://qje.oxfordjournals.org/content/126/1/517.full.pdf+html.

[30] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 39, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=39.

[31] Consumer Financial Protection Bureau, *CFPB Data Point: Payday Lending* (2014), 12, http://files.consumerfinance.gov/f/201403_cfpb_report_payday-lending.pdf#page=12. Data show "that half of all loans are in sequences of 10 or more loans; 62% are in sequences of seven or more loans." Consumer Financial Protection Bureau, *Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products* (2016), 111, http://www.consumerfinance.gov/data-research/research-reports/supplemental-findings-payday-payday-installment-and-vehicle-title-loans-and-deposit-advance-products/. Data show over 80 percent of loans are reborrowed within 14 days from the same lender.

a cash infusion of some kind, including getting help from friends or family, selling or pawning personal possessions, or taking out another type of loan.[32] Frequently, these alternatives borrowers use to retire payday loan debt were available to them instead of using the loans in the first place. But desperation or unrealistic expectations, fueled by the product's unsustainable promise of debt lasting only weeks, often make comparisons with more transparent alternatives—and the fundamental decision about whether to borrow in the first place—difficult.[33] Long-term debt and high costs are the rule rather than the exception: Only 3 percent of lump-sum payday loans go to customers who use just one or two per year, and more borrowers use 17 or more loans in a year than use just one.[34] The single-payment loan, whether offered by a bank,[35] a storefront lender,[36] or an online lender,[37] simply does not work as advertised for the vast majority of borrowers.

(b) Payday loan borrowers are unusually fragile consumers

Payday and auto title loan borrowers are unusually fragile financially compared to consumers who do not rely on high-cost credit to make ends meet. Just 49 percent of all payday loan borrowers are employed full-time, 14 percent are unemployed, and 13 percent are employed part-time. Further, borrowers who self-identified as disabled or unemployed in Pew's national survey were the most likely to have used a loan of any employment group, with usage rates of 12 percent and 10 percent respectively.[38] High-cost loan borrowers mostly do not qualify for traditional loans because they have damaged credit histories.

Like many low- and moderate-income households, they are at risk of seeing their incomes fluctuate. Since 1979, nearly half of households in the U.S. have experienced an income gain or drop of more than 25 percent in any given two-year span.[39] And in recent years, contract employment has continued to increase–a shift often referred to as the "gig" or "sharing" economy. Data show that since 2010, 1099s (the forms that some employers fill out when

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[32] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 37, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=37.

[33] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 19-29, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=19.

[34] Veritec Solutions LLC, *Oklahoma Trends in Deferred Deposit Lending* (2011), https://www.ok.gov/okdocc/documents/2011_10_OK%20Trends_Final_Draft.pdf.

[35] Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings* (2013), http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

[36] Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings* (2013), http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf. The median storefront payday loan customer uses 10 loans in a year.

[37] David Burtzlaff and Brittny Groce, *Payday Loan Industry* (Stephens Inc., 2011). This paper notes that online payday lenders are not profitable unless borrowers use multiple loans.

[38] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 11, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=13. It is possible that unemployed people were employed at the time of their last payday loan, or that they are receiving a loan based on some other form of income, such as a benefits check.

[39] The Pew Charitable Trusts, "The Precarious State of Family Balance Sheets" (2015), http://www.pewtrusts.org/en/research-and-analysis/reports/2015/01/the-precarious-state-of-family-balance-sheets

paying contract workers more than $600) have been gaining ground and even outpacing W-2 forms. As companies drop employees and add contract workers, W-2s decrease and 1099s increase. The Census Bureau's count of non-employment businesses (i.e. independent workers) has also increased.[40] Together, these data suggest an increasing shift to hourly jobs, which could exacerbate income volatility since wages fluctuate with varying work schedules.

Swings in income can destabilize a family's finances by making it difficult to budget and meet monthly expenses, including loan payments. Data from the U.S. Financial Diaries Project show that for households living below the poverty line, 26 percent of monthly income is unpredictable compared with only 9 percent for those earning 200 to 300 percent of the poverty line.[41]

This shift will likely have a greater impact on lower-income households. Research shows that poorer households experience higher rates of income volatility than their middle-income counterparts,[42] and low-income households with children and people with disabilities are among those more likely to experience sharp income declines.[43] Further, research on work schedules for young adults shows that part-time employees experience a higher level of work-hour instability and lower averages of work hours, and that fluctuations in work hours may result in financial insecurity.[44]

Recent research has also found that highly-indebted households' consumption is more sensitive to income shocks. Because these households devote a greater share of their income to fixed monthly debt payments, they have less room to cut non-essential expenses when faced with an income loss. (See Appendix F for a more detailed discussion of the research on income volatility.)

In short, the population of borrowers seeking covered loans is more fragile than nonborrowers, and will be exposed to a great deal of risk, especially considering that most borrowers earn less than $40,000 annually, struggle to make ends meet, and seek the loans for consumption-

[40] Justin Fox, "The Rise of the 1099 Economy," *Bloomberg View*, Dec. 11, 2015, https://www.bloomberg.com/view/articles/2015-12-11/the-gig-economy-is-showing-up-in-irs-s-1099-forms.

[41] Anthony Hannagan and Jonathan Morduch, *Income Gains and Month-to-Month Income Volatility: Household evidence from the US Financial Diaries*, 2015, 1, https://static1.squarespace.com/static/53d008ede4b0833aa2ab2eb9/t/553521dae4b048e6faa46cdb/1429545456581/paper1.pdf#page=1. The authors summarized income volatility by an average coefficient of variation of monthly income, which was 55 percent for those below the poverty line and 34 percent for those from 100-300 percent of the poverty line.

[42] Gregory Mills and Joe Amick, "Can Savings Help Overcome Income Instability?" *The Urban Institute*, 6, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412290-Can-Savings-Help-Overcome-Income-Instability-.PDF#page=6. Coefficient of variation for monthly household income in lowest quintile was 0.499 and 0.321 for middle quintile.

[43] Gregory Acs, Pamela Loprest, and Austin Nichols, "Risk and Recovery: Understanding the Changing Risks to Family Incomes" (2009), *The Urban Institute*, http://www.urban.org/sites/default/files/alfresco/publication-pdfs/411971-Risk-and-Recovery-Understanding-the-Changing-Risks-to-Family-Incomes.PDF.

[44] Susan J. Lambert, Peter J. Fugiel, and Julia R. Henly, "Precarious Work Schedules among Early-Career Employees in the US: A National Snapshot," *University of Chicago*, 12, https://ssascholars.uchicago.edu/sites/default/files/work-scheduling-study/files/lambert.fugiel.henly_.precarious_work_schedules.august2014_0.pdf#page=14.

smoothing rather than wealth-building purposes. Even if these loans are underwritten, low-income consumers are disproportionately likely to experience income shocks that will diminish their ability to repay.

(c) Payday and title lenders have unusually strong leverage over consumers to ensure their ability to collect loan payments

As Pew has previously discussed,[45] payday lenders are unique in that they do not use traditional underwriting to determine whether the borrower has the ability to repay the loan while fulfilling other obligations.[46] They focus primarily on the ability to collect repayment, using leveraged payment mechanisms such as deferred presentment (holding the borrower's check or having electronic access to the borrower's checking account).[47] Many other types of lenders use electronic access as a way of ensuring and streamlining repayment, but conceptually, electronic repayment plans differ from deferred presentment arrangements for several reasons: 1) payday lenders condition credit on use of a leveraged payment mechanism; 2) the repayment is tied to a borrower's payday, meaning lenders are first in line to get paid before the borrower's other creditors; and 3) borrowers can cancel the plans with other lenders and retain control over the inflows and outflows of their checking accounts. Thus, payday lenders have unusually strong ability to collect unaffordable payments, which sets them apart from other creditors.

A leveraged payment mechanism becomes a dangerous tool when it lacks limits and is coupled with a high-cost loan to a financially fragile borrower. For storefront loans, borrowers are required to return to the store to repay the loan in cash, or if they cannot afford the full payment, to pay the fee to renew it and extend the due date; if the borrower does not return, the lender can deposit the check or use ACH to debit the full loan amount. For online loans, electronic access is almost universal, as there is a strong disincentive for the borrower to choose an alternate method of applying for, receiving, and repaying the loans by mail.[48] Auto title

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[45] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 27, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=33

[46] Some providers have begun to create automated underwriting models that assess more than just whether someone has a checking account and an income stream, but do not engage in an assessment of all of the borrower's expenditures and liabilities to assess their ability to pay the loan because they still retain the ability to collect via the leveraged payment mechanism.

[47] Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings* (2013), 44, http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf#page=44. "Lenders may instead rely on their relative priority position in the repayment hierarchy to extend credit without regard to whether the consumer can afford the loan. This position, in turn, trumps the consumer's ability to organize and prioritize payment of debts and other expenses."

[48] "Frequently Asked Questions," CashNetUSA, accessed Sept. 28, 2016, https://www.cashnetusa.com/faq.html#. For example, see the following response regarding CashNetUSA loan terms in Alabama to the question: "What if I want to make payments without agreeing to the ACH authorization portion of the loan contract?" The response: "If you would like to make payments without agreeing to the ACH authorization portion of the contract, you can follow the procedures below: 1. Print out the loan contract, cross out the ACH authorization agreement and initial next to the section. 2. Provide us with a post-dated check (using the date of your next payday) for the amount of your total payment, including principal and fees, and a copy of the contract via mail, FedEx, or another delivery service. 3. We will confirm the issuing of your loan once we receive these documents."

lenders also retain strong leverage through the use of a car title, which can lead to repossession of a borrower's vehicle as a consequence of falling behind on loan payments. The threat of repossession alone is enough to make borrowers return to the lender to make a payment to extend the term for another pay period or month.

This mechanism allows the lender to compel payment on an unaffordable loan. This explains why defaults, charge-offs, and losses are all artificially low in this market even though borrowers often struggle to repay and repeatedly renew the loans. In short, lenders of covered loans hold unusually strong leverage over unusually fragile borrowers.

(d) What do borrowers want?

New Borrower Survey (August 2016)

In August 2016, Pew surveyed 826 *payday loan borrowers* to gauge their views on payday lending, the key elements of the Bureau's notice of proposed rulemaking, and possible outcomes of the rulemaking. (See Appendix A for methodology and topline results.) The survey found that:

- 70 percent of borrowers believe that payday loans should be more regulated. This finding is consistent with Pew's 2013 survey finding that 72 percent of payday loan borrowers said they wanted more regulation.[49]

- Borrowers support requiring installment payment structures: More than 3 in 4 borrowers say it will be a major improvement if they are given several months to repay a loan and if they can repay it in smaller installments. Pew's 2013 survey had similar results.[50]

- Borrowers saw loans' prices, the affordability of payments, and whether they could obtain them from banks and credit unions as important, while most did not view additional underwriting as a major improvement for them.

- When deciding where to get a loan, borrowers ranked the top three factors as: 1) the fees charged, 2) how quickly they can get the money, and 3) certainty of approval.

[49] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 48, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=48.
[50] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 22, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=28

- 8 in 10 borrowers would prefer to borrow from a bank or credit union if they were equally likely to be approved. And 93 percent of borrowers would view it as a good thing if banks and credit unions offered small loans at prices 6 times lower than payday lenders. (Pew has concluded that this would be possible if the Bureau adjusts its rule in certain ways described in Section 6 of this letter.)

- Borrowers primarily focus on prices not the process: 92 percent of borrowers report they would choose a loan that costs six times less and was underwritten based on the consumer's income and prior relationship with the bank over a loan that went through the ability-to-repay process and is priced like a payday installment loan.

- Borrowers consider the costs when evaluating helpfulness of small loans: Only 15 percent of borrowers view loans with prices currently charged by payday lenders as very or somewhat helpful, whereas 90 percent of borrowers view the same loan at a price point six times lower as helpful.

In summary, borrowers want loans that cost less, have longer repayment terms with smaller payments, and where they have a reasonable certainty of approval. They would prefer to borrow from banks and credit unions if the loans are competitive in terms of price, speed of loan origination, and certainty of approval.

(e) What does the public support?

<u>New Public Survey (August 2016)</u>

In August 2016, Pew also surveyed *the general public* to gauge their opinions on some of the possible outcomes of the proposed rule and the types of loans that might result from it. (See Appendix B for methodology and topline results.) The survey found that:

- 70 percent of American adults believe that payday loans should be more regulated. Similar results were reported in Pew's 2015 survey.[51]

- 7 in 10 Americans want to see banks offer small loans to borrowers with low credit scores. 70 percent said that their view of a bank would be more favorable if the bank offered a $400, three-month loan for $60 (as banks are prepared to do under the 5 percent payment option if adopted in the final rule).[52]

[51] The Pew Charitable Trusts, "A Survey of Americans: CFPB Proposal for Payday and Other Small Loans" (2015), 3, http://www.pewtrusts.org/~/media/assets/2015/07/cfpb_chartbook.pdf#page=5.

[52] As discussed in Section 6 of this letter, Pew recommends adopting the "5 percent payment-to-income ratio alternative," which we also refer to as the "5 percent payment option," in the final CFPB rule.

- When asked about outcomes of regulation, 80 percent of respondents said that if borrowers were given more time to repay loans but the annual interest rates continued to be around 400 percent, they would view it as a bad outcome (as is likely to happen under the longer-term ability-to-repay section of the rule; see Section 4 of this letter for discussion).

- 86 percent of respondents believe it would be a good outcome if most people who use payday loans could obtain lower-cost credit from their banks and credit unions (as is likely to happen under the 5 percent payment option).

- Respondents were asked about a $400, 3-month loan. They overwhelmingly favor loans with lower prices, regardless of process: 79 percent believe it would be a better outcome if a loan was issued based on a customer's checking account history with a $60 fee (as is likely to happen under the 5 percent payment option), versus just 13 percent who believe a better outcome would be the proposed ability-to-repay process with a $350 fee.

- Respondents view the prices charged for payday installment loans that are likely to continue under the longer-term ability-to-repay section of the proposed rule as unfair.

- By almost 5 to 1, respondents believe it would be a good thing if banks began offering small loans at prices six times lower than payday lenders (as is likely to happen under the 5 percent payment option), even when they are told the rates would be higher than those for credit cards.

These findings reveal that when evaluating effectiveness of regulation, Americans focus on loans' costs rather than the process lenders use to originate them, and they overwhelmingly favor banks offering lower-cost small loans to borrowers with low credit scores. As discussed later in this letter, the CFPB could help achieve this outcome by finalizing the 5 percent payment-to-income ratio alternative in its final rule. Even though the Bureau lacks the power to regulate prices, opening the market to competition from lower-cost providers according to clear product safety guidelines would result in safer loans that save borrowers money.

(f) Key problems in the market

Pew's research identified the following key problems in the market:

i. Unaffordable payments enforced by leveraged payment mechanisms (typical payments take more than one-third of borrower paychecks when most borrowers cannot afford to pay more than 5 percent)

A typical payday loan payment takes 36 percent of an average borrower's gross monthly income, and the average lump-sum auto title loan payment consumes 50 percent of the borrower's paycheck.[53] Most borrowers cannot afford to lose this much from their paycheck and still make ends meet, yet lenders use leveraged payment mechanisms to ensure their ability to collect anyway. This leads borrowers to renew or reborrow their loans repeatedly. As a result, a typical borrower, who takes out a $375 two-week loan, is indebted for almost five months of the year, and pays $520 in fees instead of the originally contracted fee amount of $55.[54]

Simply giving borrowers more time to repay, however, will not guarantee that these loans will be affordable. For example, a $500 installment loan that is currently offered in Texas requires a monthly payment of about $300,[55] far more than average payday borrowers say they can afford ($100 per month). Whenever installment loans require payments beyond borrowers' ability to repay, they are at risk of not being able to cover other expenses, especially when the lender has access to a leveraged payment mechanism.[56] Research shows that most payday borrowers cannot afford loan payments that take up more than 5 percent of their gross monthly income. Moreover, analysis of loans from installment lenders that do not have access to leveraged payment mechanisms reveals that monthly payments generally do not exceed 5 percent of borrower's monthly income. (See Appendix C for a description of numerous data sources that support a 5 percent payment-to-income ratio.)

ii. Deceptive business model

Although conventional two-week payday loans are advertised as a quick short-term solution for unexpected expenses, the average borrower is in debt for five months during the year. Data from lenders' filings and industry officials' testimonies reveal that renewals are an essential part of the payday lending business model: If borrowers were using single-

[53] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 31, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=37 The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences* (2015), 1, http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf#page=5.

[54] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 9, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=11.

[55] "Extended Loan," Advance America, accessed Oct. 3, 2016, https://www.advanceamerica.net/locations/details/store-3120/2445-Fulton-Ste-C/Houston/TX/77009. The referenced Advance America loan is available in Texas as an extended loan.

[56] See Section 5 for more detailed discussion about why having access to leveraged payment mechanism enables high-cost lenders to issue unaffordable loans while shielding themselves from risk that borrowers will not pay them back (something the Bureau refers to as the lender's "ability to collect").

payment loans as advertised, the lenders would go out of business.[57] As the CFPB has noted, four in five loans are taken within two weeks of a previous loan. Data from Florida show that approximately 97 percent of loans go to those who use three or more annually, and about 3 in 5 go to those who use 12 or more loans.[58] Data from Oklahoma show that more borrowers use 17-plus loans in a year than just one.[59] To ensure that loans work as advertised, they should have affordable installment payments that fit into a borrower's budget and pay down principal. In addition, all fees and charges should be clearly disclosed and be pro rata refundable to reduce the incentive for lender-driven refinancing. Before Colorado's 2010 reform, a loan's advertised price represented 13 percent of finance charges actually paid in a year, whereas after the 2010 reform, the advertised price represented 87 percent of actual annual spending.[60]

iii. Origination fees and other lender incentives to refinance

When small loans carry an origination fee, lenders can earn a substantial portion of revenue at the outset of the loan. This creates a strong incentive to encourage borrowers to refinance so that the lender earns another origination fee. Similarly, when interest front-loading applies, lenders earn a disproportionate amount of income in the early months of the loan, creating an incentive to encourage refinancing.[61]

Frequent lender-driven refinancing places borrowers at risk of financial harm because of the additional fees, interest payments, and months of debt. They can also mask defaults by renewing unaffordable loans to avoid borrowers defaulting when they cannot afford a loan payment. However, the solution to this problem lies not with rationing the number of loans a borrower can take out, but with eliminating lender incentives to refinance loans. If the loan is structured in a way that makes every month of the loan equally profitable, then the lender does not have an incentive to encourage refinancing (and a refinance does not include a *de facto* prepayment penalty for borrowers). If borrowing is not limited (for example, at to two times per six months or year), the customer will borrow only what they need and prepay when possible.[62] Eliminating lender incentives to refinance without placing

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[57] John Robinson, president of TitleMax Holdings LLC, "Affidavit of John Robinson, President of the Debtors, in Support of First Day Motions and Applications," 11, April 21, 2009, U.S. Bankruptcy Court for the Southern District of Georgia, Savannah Division, http://s3.documentcloud.org/documents/1227212/tmx-exec-delcaration-in-bk-case.pdf; Robert DeYoung and Ronnie J. Phillips, *Payday Loan Pricing* (Federal Reserve Bank of Kansas City Economic Research Department, 2009), https://www.kansascityfed.org/PUBLICAT/RESWKPAP/PDF/rwp09-07.pdf.

[58] Veritec Solutions LLC, *Florida Trends in Deferred Presentment* (2010). On file with The Pew Charitable Trusts.

[59] Veritec Solutions LLC, *Oklahoma Trends in Deferred Deposit Lending* (2011), https://www.ok.gov/okdocc/documents/2011_10_OK%20Trends_Final_Draft.pdf.

[60] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 12, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=18

[61] National Consumer Law Center, *Installment Loans: Will States Protect Borrowers From A New Wave Of Predatory Lending?* (2015), 22, http://www.nclc.org/images/pdf/pr-reports/report-installment-loans.pdf#page=32.

[62] In general, it is unnecessary to ration safe loans; however, when it is not possible to make the underlying loan safe—as in the proposed short-term conditional exemption—Pew supports loan limits.

limits on borrowers' ability to access safer credit will lead to less indebtedness and lower consumer cost.

iv. Defaults

Payday loan borrowers' low credit scores mean they are at higher risk of defaulting on any loan. And yet defaults for these and other covered loans are much lower than they could be because of the lender's use of a leveraged payment mechanism. This creates artificially low default rates because it allows lenders to compel repayment (either the full amount or a fee to renew the loan, effectively masking a default), even though the borrower may be struggling to meet other obligations. When lenders do not have a leveraged payment mechanism, such as in the credit card market or traditional installment loan market for example, default rates are generally less than 10 percent even on subprime loans to borrowers who do not have prime credit scores.[63]

In addition to its proposed rule for payday, auto title, and similar loans, the CFPB also published new data examining default rates in this market. These high-cost, nonbank payday installment loans, obtained via stores or the Internet, have high default rates. The results from the Bureau's analysis show a clear correlation between a decrease in payment sizes and a corresponding decrease in defaults. While it stands to reason that smaller payments are associated with fewer defaults, this finding corroborates national data from the subprime installment loan market where 85 percent of underwritten loans have payments that do not exceed 5 percent of a borrower's income.[64]

However, this relationship changes when the origination channel is unspecified–meaning it is unknown whether the borrower obtained the loan from a store, the Internet, or another source. The differences in higher default rates for loans with unspecified origination channels are consistent across loan types. For example, auto title loans with 12-month terms and payment sizes that do not exceed 5 percent of a borrower's income have a default rate of about 13 percent; for the same loans from online payday installment lenders, the rate is about 30 percent; and for loans where the origination channel is unspecified, 40 percent. Even across all loans irrespective of the term, payment size, and lender, this relationship remains intact.

The Bureau also found an odd inverse relationship between payment size and repayment for payday installment loans (that is, defaults were higher for lower payment sizes). This

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[63] World Acceptance Corporation, *2015 Annual Report*, http://www.worldacceptance.com/wp-content/uploads/2015/07/2015-ANNUAL-REPORT_6-25-15.compressed.pdf; Regional Management, *2015 Annual Report*, http://www.regionalmanagement.com/phoenix.zhtml?c=246622&p=irol-sec#14225200; Springleaf Financial, *2014 Annual Report*, http://files.shareholder.com/downloads/AMDA-28PMI5/1248530341x0x823670/5A26396A-A4D8-4870-B693-B8F6B87F954A/Springleaf_2014_AR10K.pdf.

[64] Dataset on file with The Pew Charitable Trusts.

result likely arises from the fact that only the smallest payday installment loans have a PTI ratio below 5 percent, with payday installment lenders offering small amounts to applicants who appear to be the riskiest borrowers. (As an example, at a typical payday installment loan APR of 400 percent, it would not be possible to lend a typical payday loan borrower even $350 under a 5-percent/6-month standard.)

Online payday installment lenders have reported to Pew explicitly that they would be unable to operate profitably under a 5 percent payment provision, and a review of their public filings corroborates this assertion. Losses, servicing costs, and customer acquisition costs would typically render such a loan unprofitable. Instead, lenders appear to be using small loans as loss leaders to acquire customers who would then qualify for profitable loans with larger payments and longer terms (which would be offered under the longer-term ability-to-repay section under the proposed rule). This dynamic, where higher borrower risk is associated with smaller loans and smaller PTI ratios may explain why when CFPB researchers conducted a deeper analysis "[c]ontrolling for various borrower characteristics, loan features, originating lender, and seasonality" they found that "on average, a lower PTI ratio is associated with higher likelihood of paying off the loan."[65]

The proposed rule stipulates that lenders' default rates will be compared to those of their peers, but it does not dictate a threshold. As written, the Bureau's ability-to-repay standard is likely to result in continued high defaults from high-cost lenders because they can cover losses by charging excessive fees. Lower-cost providers, on the other hand, would not be able to offer loans profitably if defaults exceeded 10 percent; therefore, they would need to keep default rates low. For example, four lenders—Community Loan Center of Texas, Kinecta Federal Credit Union, St. Louis Community Credit Union, and Spring Bank—that are making loans with payments no greater than 5 percent of income report low default rates, typically in the range of 3-6 percent.[66]

v. Unnecessarily long repayment terms

Ensuring that borrowers have more time to repay and requiring installment payments is imperative but not sufficient to protecting consumers. In some cases, lenders have set up terms that are unnecessarily long to derive more revenue from borrowers without incurring more risk. For example, a $500 auto title loan that is currently offered in Arizona has a

[65] Consumer Financial Protection Bureau, *Supplemental findings on payday, payday installment, and vehicle title loans, and deposit advance products* (2016), 29, http://www.consumerfinance.gov/data-research/research-reports/supplemental-findings-payday-payday-installment-and-vehicle-title-loans-and-deposit-advance-products/.
[66] Center for Financial Services Innovation, *Designing High-Quality, Small-Dollar Credit: Insights from CFSI's Test & Learn Working Group* (2015), 6, http://www.cfsinnovation.com/Document-Library/Designing-High-Quality,-Small-Dollar-Credit-Insig; The Dallas Morning News Editorial Board, "Finding innovative alternatives to payday lenders," *The Dallas Morning News*, Sept. 15, 2014, http://www.dallasnews.com/opinion/editorials/2014/09/14/editorial-finding-innovative-alternatives-to-payday-lenders. Spring Bank loss data on file at Pew. St. Louis Community Credit Union's program does not yet have published data.

repayment period of 18 months and carries $1,126 in fees.[67] The same $500 loan that banks were preparing to offer using the 5 percent payment standard would be outstanding for about 6 months and cost seven to eight times less.[68] Pew's survey found that respondents believe that four to six months is a reasonable term for a $500 loan.[69] Placing reasonable limits on how long a lender may hold a leveraged payment mechanism would help curb the harm caused by unnecessarily long terms.

vi. Abuse of leveraged payment mechanisms

Online payday loan borrowers are at especially high risk of unauthorized withdrawals because their bank accounts are exposed to lenders and sometimes others who buy their information from lenders or lead generators. Research shows that lenders have repeatedly accessed borrowers' accounts when debits fail, causing multiple overdraft fees. In Pew's national survey, 46 percent of online borrowers reported that their bank accounts were overdrawn by payday lenders' withdrawals, twice the rate among storefront borrowers.[70] Further, 22 percent of borrowers reported closing their checking accounts or having them closed by their bank in connection with an online payday loan.[71] Unscrupulous lenders have also been shown not to honor borrowers' requests to cancel the loans,[72] and there can be lag time between the request and when it takes effect,[73] demonstrating that safeguards are needed to protect against aggressive or fraudulent practices. Many unscrupulous lenders have been targets of judicial[74] and regulatory[75] actions because of the propensity for abuse via the ACH system, which is atypical of depository institutions that are subject to prudential regulatory oversight, underwrite their customers, and offer lower-cost loans.

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[67] "Arizona Rates and Terms," Speedy Cash, accessed Oct. 3, 2016, https://www.speedycash.com/rates-and-terms/arizona. The referenced Speedy Cash loan is available in Arizona as an auto title installment loan.

[68] Ian Mckendry, "Banks' Secret Plan to Disrupt the Payday Loan Industry," *American Banker*, May 6, 2016, http://consumerbankers.com/cba-media-center/cba-news/banks-secret-plan-disrupt-payday-loan-industry.

[69] The Pew Charitable Trusts, "A Survey of Americans: CFPB Proposal for Payday and Other Small Loans" (2015), 5, http://www.pewtrusts.org/~/media/assets/2015/07/cfpb_chartbook.pdf#page=7.

[70] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 32–35, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=32.

[71] The Pew Charitable Trusts, *Fraud and Abuse Online: How Borrowers Choose and Repay Payday Loans* (2013), 16, http://www.pewtrusts.org/~/media/assets/2014/10/payday-lending-report/fraud_and_abuse_online_harmful_practices_in_internet_payday_lending.pdf#page=20.

[72] Federal Trade Commission, "Online Payday Loans," accessed Sept. 28, 2016, https://www.consumer.ftc.gov/articles/0249-online-payday-loans. The FTC discusses recent lawsuits against online payday lenders for alleged violations of federal laws.

[73] Baptiste and Brodsky v. JP Morgan Chase Bank, filed Oct. 1, 2012, http://www.neweconomynyc.org/wp-content/uploads/2014/08/Baptiste-v.-Chase-complaint-FINAL.pdf. This is a complaint in a high-profile case of withdrawals by online payday lenders resulting in large bank fees for borrowers.

[74] Nick Bourke, Fintech Law Report, *Online Lending and the Integrity of the Banking System: Behind the Heated Rhetoric Over "Operation Choke Point,"* Mar/Apr 2015, Volume 18, Issue 2, pp. 5-6, http://www.pewtrusts.org/~/media/assets/2015/05/fintech1802_aa_bourke_proofed.pdf?la=en#page=5.

[75] NACHA, "ACH Network Risk and Enforcement Topics," Aug. 26, 2014, https://www.nacha.org/rules/ach-network-risk-and-enforcement-topics.

Auto title loan borrowers are also at risk of harm due to lenders' ability to repossess their cars. Lenders often charge repossession-related fees to reduce or avoid losses on defaulted loans and to earn additional revenue. This drives up the cost for borrowers who repay and retrieve their cars and reduces any potential surplus refund for those whose cars are sold at auction. Because lenders add these fees to the outstanding debt, borrowers rarely receive any net profits from the car sale though it is typically mandated by state law. It should be noted that these fees are not a core part of the title loan business model.[76]

vii. Weak price competition

Borrowers of high-cost loans show little sensitivity to price because they are not shopping for credit, but rather looking for quick cash to meet an urgent need, usually paying a bill. Lenders recognize this behavior and therefore do not compete on price, and instead, compete on non-price elements, such as location, certainty of approval, and customer service.[77] The same lenders charge different prices to similarly situated borrowers across states. For states with usury caps, lenders typically charge the ceiling, and in states with no rate caps, lenders charge even higher prices.[78] For example, on a $500 loan, the same lender charges 664 percent APR to borrowers in Texas, but 391 percent APR to borrowers in Kansas.[79] Yet, in states with lower rate limits, payday credit is not significantly constrained; instead, fewer stores simply serve more customers each.[80] For example, in the five years after Colorado lowered permissible interest rates for payday loans, more than half of stores closed; but each remaining store doubled its average customer count. Borrowers' access to credit in the state was virtually unchanged.[81]

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[76] Tennessee Department of Financial Institutions, *2016 Report on the Title Pledge Industry* (2016), 11, http://www.tennessee.gov/assets/entities/tdfi/attachments/Title_Pledge_Report_2016_Final_Draft_Apr_6_2016.pdf#page=14 In Tennessee, lenders report spending 3 percent of revenue on repossession expenses;
Jim Hawkins, "Credit on Wheels: The Law and Business of Auto-Title Lending," *Washington and Lee Law Review* 69, no. 2 (2012), accessed Oct. 4, 2016, 551–52, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1952084. "The notion that lenders repossess vehicles to generate significant profits is almost certainly wrong. Repossessing, storing, and selling vehicles are expensive relative to the value of most pledged vehicles. One operator estimated the costs at around $500 for his company—$250 to pay a company to repossess the vehicle and $250 to pay for the sale; another confirmed that '[r]epossessions, at best, are a breakeven process and most often simply mitigate our loss.'"

[77] There is strong evidence that borrowers would choose lower-cost options if they were aware of them and these options were competitive on these factors; see Section 3(d) and Appendix A of this letter.

[78] The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices" (2014), http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs/content-level_pages/fact_sheets/stateratelimitsfactsheetpdf.pdf.

[79] "Find Your Closest Store," Advance America, accessed Sept. 30, 2016, https://www.advanceamerica.net/locations.

[80] Robert B. Avery and Katherine A. Samolyk, "Payday Loans Versus Pawn Shops: The Effects of Loan Fee Limits on Household Use" (2011), http://www.frbsf.org/community-development/files/2-avery-paper.pdf; and Mark J. Flannery and Katherine A. Samolyk, "Scale Economies at Payday Loan Stores" (2007), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2360233. Both papers have detailed this tendency.

[81] Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report* (2010), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/2009_ddl_composite.pdf; Colorado Office of the Attorney General, *2015 Deferred Deposit Lenders Annual Report* (2016), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/2015_ddl_composite.pdf.

The Bureau cannot set prices for loans; that responsibility will continue to fall to states. However, there is merit in setting tougher compliance rules for higher-cost loans compared to lower-cost loans given the overwhelming evidence demonstrating that very high-cost loans pose great risk of harm to consumers. This is especially true when lenders have the ability to collect using a leveraged payment mechanism. Even for online lenders that use sophisticated algorithms to underwrite borrowers, prices are extremely high.

(g) Key lessons from research and reform efforts in Colorado and elsewhere

Two features of payday loans harm consumers: unaffordable payments and unnecessarily high prices.[82] Available research focuses mainly on the question of whether consumers would be better off with or without access to such high-cost loans, but because the Bureau's rulemaking will alter the market for high-cost loans rather than eliminate it, the more urgent question concerns the lessons that research and experience can provide to help ensure that reforms are effective, efficient, and beneficial to consumers. We explore this question below.

i. Research aimed at evaluating whether consumers are better off with or without access to payday loans is of little relevance to a well-designed rule

To determine whether payday and similar loans are on net beneficial, many studies have attempted to compare outcomes for people with and without access to payday loans. Most of these studies have detected small impacts in either direction or no net impact. This approach to the payday loan question made sense at a time when states primarily debated whether to have high-cost single-payment loans (with APRs in the range of 400 percent) or little access to small-dollar credit. But the choice set does not need to be limited in this way. As the Bureau has noted, high-cost credit will remain available under the proposed rule to most people who have access to it currently.

Instead, the Bureau should look to research that shows how best to reform this market in a way that reduces harm and improves consumer outcomes. Colorado's experience and the willingness of banks and credit unions to offer small loans demonstrate that this goal can be met and small credit can remain available to consumers with low credit scores and little savings, if regulations are tailored to ensure affordable payments and promote lower-cost competition.

[82] As in many other parts of this letter: We focus our discussion on payday loans but note that the discussion has broad general applicability to all forms of covered loans.

ii. Research from Colorado and elsewhere provides more relevant findings about how to *reform* payday lending while maintaining access to credit

In 2010, the Colorado legislature developed a compromise to the "loans vs. no loans" debate, which resulted in APRs averaging roughly 120 percent (with a $395 average loan repaid in 3 months at a cost of $112). Loans are repayable in small installments, and each payment reduces the loan balance. There is a six-month minimum term, three-quarters of loans are repaid early, and state law ensures there is no penalty for doing so.[83] The loans carry two fees and an interest rate, but one of the fees is not assessed until the end of the second month, so if borrowers repay early, the APR is lower.[84]

As a result of this law, average borrowers pay 4 percent of their paychecks toward loan payments compared with 36 percent nationally, and consumers saved over $50 million per year in fees in 2015 compared with 2009 (the last year before the law change).[85] State regulatory data show that five years after the law change, credit is still widely available and borrowers have both the lowest prices and most affordable payments of any state where lenders operate.[86]

Two key lessons from the Colorado reform experience are that credit can be made available at much lower prices, and that establishing affordable monthly payments and reasonable durations is essential to the success of reforms.

- Even though the Bureau lacks the power to impose the price limits set by the Colorado legislature, this examples shows that that payday installment loans lasting about six months can be made widely available to typical

[83] Because of how the law is designed, lenders have incentive to keep loan terms set as close to six months as possible; consequently, few if any loans last longer than seven months.
[84] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 7-21, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=13
[85] Colorado Office of the Attorney General, *2009 Deferred Deposit Lenders Annual Report* (2010), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/2009_ddl_composite.pdf; Colorado Office of the Attorney General, *2015 Deferred Deposit Lenders Annual Report* (2016), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/2015_ddl_composite.pdf.
[86] The Pew Charitable Trusts, "Trial, Error, and Success in Colorado's Payday Lending Reforms" (2014), http://www.pewtrusts.org/~/media/assets/2014/12/pew_co_payday_law_comparison_dec2014.pdf; Administrator of the Colorado Uniform Consumer Credit Code, "Payday Lending Demographic and Statistical Information: July 2000 through December 2009" (2010), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/DemoStatsInfo/ddlasummary2000-2009.pdf; Administrator of the Colorado Uniform Consumer Credit Code, "Payday Lending Demographic and Statistical Information: July 2000 through December 2012" (2013), http://coag.gov/sites/default/files/contentuploads/cp/ConsumerCreditUnit/UCCC/AnnualReportComposites/DemoStatsInfo/ddlasummary2000-2012.pdf. Pew's publications have also showed that while many stores close under such policies, remaining stores tend to absorb excess demand sufficient to serve the vast majority of borrowers. In Colorado, the number of borrowers has declined by only 9 percent while average loan sizes and typical borrower demographics remain virtually unchanged. Approximately 10.5 percent of loans were charged off in 2014 according to Colorado regulatory data.

payday loan customers. By setting clear standards, the Bureau can set a path to a market with prices much lower than Colorado's by enabling banks and credit unions to leverage their considerable comparative advantages over payday lenders to offer lower-cost loans. Prudential regulators will also play an important role by ensuring these loans are safe and that margins on these loans are reasonable. Borrowers are adamant that they will use such credit instead of payday loans, (see Section 3(d) of this letter for discussion and Appendix A for full results) and the experiences of credit unions and other lenders offering lower-cost small installment loans is that borrowers see their credit scores increase, improving their trajectory to qualify for still lower-cost credit.

- One of the most important outcomes of the Colorado law is the size of the loan payments. For average loans, the bi-weekly payments due are about $48, or 4 percent of an average borrower's paycheck. For $500 loans (the maximum allowed), bi-weekly installments are $61, or 5 percent of an average borrower's paycheck. The percentage of income taken by loan payments is similar to what a variety of research shows is affordable for typical borrowers (Appendix C summarizes relevant national survey and focus group, consumer credit bureau, installment loan trade association, multiple installment loan provider, and payday loan data).

  By extending the loan terms to ensure that loans would be repaid in about six months and reducing monthly payments to an affordable level, the law enabled borrowers to repay while still covering their other expenses. The CFPB can replicate this success directly by limiting the size of installment payments to 5 percent of a gross paycheck or 6 percent of deposits into an account, or indirectly by discouraging loans that do not conform to these benchmarks.

The harm that payday loans cause to consumers—and the potential for achieving better consumer outcomes through regulatory reform—comes into stark relief when the loans are compared with the lower-cost credit that banks are proposing to offer to consumers if the final rule enables them to do so.[87] These loans would cost roughly six times less than average payday loans, and about 10 times less than loans in states like Ohio where prices are not constrained by rate limits.

[87] We discuss this issue throughout the rest of this letter. *American Banker* reported in May 2016 that at least three large banks were planning to use the 5 percent payment option the CFPB proposed in its 2015 SBREFA outline to offer small loans repayable in affordable installment at prices roughly six times lower than average payday loans.

Cost of borrowing $400 for 3 months in selected states

Ohio	$600+
Alabama	$420
Kansas	$360
Michigan	$327
Florida	$270
Colorado	$120
Banks (5% payment loans)*	$60

Note: All prices come from payday lenders' websites. All state prices reflect the maximum allowed, except Ohio, where lenders operate without limits. *See Sections 4, 5, and 6 of this letter for discussion.

The roughly $9 billion that borrowers spend annually on payday loan fees (as part of the more than $30 billion that consumers spend annually on finance charges for small nonbank credit)[88] drains household resources, and unaffordable loan payments result in poor outcomes for borrowers, including an inability to cover living expenses without borrowing again. Other negative outcomes include checking account overdrafts caused by payday lenders' withdrawals, requiring help from family or friends to repay loans, repossession of vehicles to auto title lenders, and loss of checking accounts (twenty-two percent of online payday loan borrowers have closed or lost an account in association with an online payday loan).[89]

The additional fees that a payday loan borrower pays to use $500 for 3 months in a state like Ohio compared with the cost of a loan that banks would offer that customer amount to a week of income for an average borrower. Colorado's success, and banks' apparent willingness to serve their checking account customers who are turning to payday lenders today, demonstrates that the choice facing the CFPB is whether to implement clear policies to ensure affordable periodic payments and create the circumstances in which consumers will gain access to credit at prices six to eight times lower than today. Though the CFPB lacks the authority to mandate all aspects of covered loan terms—such as maximum allowable finance charges—that does not mean that the Bureau cannot significantly improve the market for covered loans by exercising the authority it does have. Further, the authority to limit interest rates (but maintain the availability of credit in the nonbank market) would be unlikely to lower loan prices as much as drawing banks and credit unions into the market. The reason for this is that nonbank providers simply cannot match the low costs of origination, losses, and servicing that banks and credit unions would have under streamlined regulations.

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[88] Center for Financial Services Innovation, *2014 Underserved Market Size: Financial Health Opportunity in Dollars and Cents* (2015), 8-12, http://www.cfsinnovation.com/CMSPages/GetFile.aspx?guid=ac5235a9-a42a-434c-a26a-66a1b148b712#page=8.
[89] The Pew Charitable Trusts, *Fraud and Abuse Online: Harmful Practices in Internet Payday Lending* (2014), 16, http://www.pewtrusts.org/~/media/assets/2014/10/payday-lending-report/fraud_and_abuse_online_harmful_practices_in_internet_payday_lending.pdf#page=20.

Section 6 of this letter includes recommendations. The CFPB can replicate and improve upon Colorado's success in the nonbank market by making the ability-to-repay test much tougher and including a Colorado-like alternative that lenders could use to provide safer loans at lower cost.

4. Estimated Impact of the Proposed Rule

(a) Lenders already make covered longer-term loans in 28 states and at least six others are vulnerable

i. Migration to multi-payment loans is well underway and is likely to continue

The foremost impact of the proposed rule would be to shift the market from high-cost single-payment loans to high-cost multi-payment loans. This transition away from single-payment loans is a positive and necessary one, though it is not sufficient to protect consumers. Payday and auto title lenders are already issuing high-cost installment loans or lines of credit in 28 of the 41 states where they operate today.[90] In these states, lenders will continue making loans that have no federal restrictions on cost, payment size, or the length of time they can access a bank account or car title as long as they document a borrower's income, credit report obligations, and estimate similar people's expenses. As a result, high-cost covered loans will thrive in at least 28 states.

Moreover, in the remaining states lenders will likely accelerate their efforts to modify state installment, line of credit, and brokerage laws to allow high-cost lending. For example, in 2016 Mississippi passed legislation that enabled high-cost auto title installment lending, and payday lenders started offering lines of credit with all-in APRs greater than 300 percent in Maryland, a restrictive state that does not have traditional payday lending.[91]

In addition, in at least six states lenders may try to take advantage of credit services organization (CSO) or credit access business (CAB) statutes that allow loan brokering. In 2016, a high-cost lender started offering loans using a CSO statute in Arkansas, a previously restrictive state with no traditional payday lending.[92] In states such as Ohio and Texas, where lenders already issue loans using CSO and CAB statutes, APRs often exceed 500 percent because their statutes do not impose limits on brokerage fees. State-licensed online lenders are also issuing high-cost multi-payment loans in a majority of states, although the CFPB's proposal to limit withdrawal attempts would provide certain protections to online borrowers.

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[90] The Pew Charitable Trusts, "From Payday to Small Installment Loans: Risks, Opportunities, and Policy Proposals for Successful Markets" (2016), 5, http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf#page=5. These states are the 26 identified in the cited brief, as well as Arkansas and Maryland.

[91] Ted Carter, "Mississippi's expansion of short-term lending starts July 1," *Mississippi Business Journal*, May 26, 2016, http://msbusiness.com/2016/05/mississippis-expansion-of-short-term-lending-starts-july-1/; "Rates and Terms," CashNetUSA, accessed Oct. 4, 2016, https://www.cashnetusa.com/rates-and-terms.html. CashNetUSA started offering high-cost lines of credit in Maryland.

[92] Brian Fanney, "CashMax fees break state law, North Little Rock says," *Arkansas Online*, Aug. 5, 2016, http://www.arkansasonline.com/news/2016/aug/05/cashmax-fees-break-state-law-nlr-says-2/?f=news-arkansas#/.

To sum up, in at least 28 states lenders will likely continue issuing high-cost covered installment loans and lines of credit, and other states are vulnerable because lenders will continue to reinterpret or modify laws as the single-payment payday and auto title loan markets become more restricted. The Bureau needs to set clear product safety standards for small-dollar loans so that states will have a model with clear guidelines that they can build on to regulate this rapidly evolving market for installment loans and lines of credit.

ii. The rule lacks standards to help guide this migration effectively

The proposed federal rule includes a process for issuing loans but fails to provide guidelines to help other policy makers refine local rules that govern state-licensed lenders. There are no guidelines to help distinguish between safe or high-quality loans, on the one hand, and unsafe or low-quality loans on the other. In fact, the Bureau's discussion of the ability-to-repay test would appear to condone high-cost loans with monthly payments that far exceed what most borrowers can actually afford. (See Section 5 of this letter for discussion.) As a result, high-interest installment loans are likely to continue proliferating without states having a model in place to help balance credit access with consumer protection as this market evolves.

Alabama's state senate passed a bill 28-1 in 2016 to reform their payday loan law in a way that was similar to Colorado's, while Nebraska and Hawaii also introduced bills modeled on Colorado's success.[93] (See Section 3(g) of this letter for discussion of Colorado's reform model.) If the Bureau included clear indicators as to how states could keep credit available with strong consumer protections, including lower prices, affordable payments, costs spread evenly over the life of the loan, and reasonable loan lengths, states that chose to do so could adopt these reforms. Under the process-heavy proposed rule that lacks clear guidance and adds time and cost to the origination process, states do not have a straightforward model to utilize and effective reform becomes less likely.

Payday lines of credit and installment loans on the market today typically cost three to four times more than Colorado's payday installment loans, demonstrating the cost to consumers of this failure to include a state model. Further, the additional staff time and cost of the ability-to-repay process also threaten Colorado's success by adding cost for lenders that have more than doubled their efficiency since Colorado's 2010 reform. In particular, in states without price limits, or in states that raise permissible prices in

[93] Brian Lyman, "Alabama Senate approves payday loan reform bill," Montgomery Adviser, April 5, 2016, http://www.montgomeryadvertiser.com/story/news/politics/southunionstreet/2016/04/05/alabama-senate-approves-payday-loan-reform-bill/82681854/; Lincoln Journal Star Editorial Board, "Improve Payday Loans," *Lincoln Journal Star*, Feb. 20, 2016, http://journalstar.com/news/opinion/editorial/editorial-improve-payday-loans/article_a6ff3e4c-d95d-5ee8-ab48-0494244d6c2b.html.

response to the federal rulemaking, payday and title lenders may pass these additional costs along to consumers.[94]

(b) Most of today's borrowers will continue receiving high-cost loans with unaffordable payments

Industry analysts estimate that most payday loan borrowers will pass an underwriting test for payments of at least $200 per month, even though most borrowers report that they can truly afford only $100.[95] Moreover, the Bureau's analysis of Tables 3 to 6 of the proposed rule implies that most borrowers with annual household income above $18,000 (a typical payday borrower makes $30,000 a year) will demonstrate the ability to repay some amount.[96] The proposed rule also notes that the median monthly payment for a vehicle title installment loan is $230. The Bureau writes "Table 3 shows that most borrowers would appear to need at least $1,500 in household income to be able to demonstrate an ability to make a $230 monthly payment. A more likely scenario is that they would actually need $2,500 or $3,000 in household income to support such payments, given the additional major financial obligations borrowers may have, other basic living expenses not included in these calculations, and the need to provide an additional cushion on covered longer-term loans."[97] Analysis of loans currently offered by payday lenders shows that most very high-cost payday installment loans have monthly payments of less than $230.[98] Lenders can also adjust payments on very high-cost loans to ensure applicants qualify for them. Speedy Cash's $500 auto title installment loan in Arizona carries monthly payments of just $90.35 for 18 months, so borrowers repay more than $1,600 on a $500 loan.[99] Speedy Cash's $300 payday installment loan in Missouri carries bi-weekly payments of just $49.61, but it lasts 18 months, so borrowers repay more than $1,800.[100]

The continued widespread availability of such loans without lower-cost options would mean that most borrowers would be likely to receive loans and pay more in fees than they received in credit. (See Appendix E for examples of high-cost installment loans currently offered in 28 states.) These figures also suggest that borrowers will continue to be harmed by unaffordable payments because $230 monthly is roughly double what borrowers earning $2,500 to $3,000 report being able to afford toward loan payments and substantially higher than what empirical

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94 See discussion at footnote 134.

95 Clarity Services, "Nonprime101 Conference 2015," St. Petersburg, Florida, Aug. 4-5, 2015, https://www.nonprime101.com/wp-content/uploads/2015/08/NP101-Rick-Hackett.pdf#page=48. Report that about 8 in 10 of traditional storefront payday and installment, and online borrowers will have at least $201.26 per month in residual income that could be put towards loan payments under the outlined ability-to-repay test.

96 81 F.R. 48123.

97 81 F.R.48137.

98 As noted in Appendix E, most of the high-cost installments loans currently offered by payday lenders have monthly payments below $230.

99 "Arizona Rates and Terms," Speedy Cash, accessed Sept. 28, 2016, https://www.speedycash.com/rates-and-terms/arizona. The referenced Speedy Cash loan is available in Arizona as an auto title installment loan.

100 "Missouri Rates and Terms," Speedy Cash, accessed Sept. 28, 2016, https://www.speedycash.com/rates-and-terms/missouri. The referenced Speedy Cash loan is available in Missouri as a payday installment loan.

research suggests they can actually afford, raising serious questions about the benefit to consumers of the proposed ability-to-repay test.

The proposal explicitly acknowledges that "given the substantially higher average incomes of payday installment borrowers, as seen in Table 6, it appears that a majority would be able to demonstrate an ability to repay a typical payday installment loan" with a median monthly installment payment of $304. The median monthly income of payday installment loan borrowers is less than $3,000. The Bureau's assertion that payday loan borrowers can afford more than 10 percent of their periodic income toward high-interest loan payments directly contradicts borrowers' views of what they can afford.

By contrast, a 5 percent payment option would result in payments similar to those that borrowers report being able to afford and what empirical research shows is actually affordable. (See Section 6 of this letter for discussion.)

(c) Vague and compliance-heavy requirements exacerbate barriers to lower-cost loans

i. Proposal would effectively prohibit scalable, lower-cost loans

The Bureau's proposal focuses heavily on process, documentation, and compliance. The proposed ability-to-repay requirements introduce a mandate for at least two external data pulls, a real-time database, uncertainty about regulatory expectations of the proposed "reasonable determination," and an inability to automate the prescreening, underwriting, and origination process, preventing banks and credit unions from offering loans.

Pew has interviewed several dozen banks and credit union executives about the draft rule, and not one of them has said they could be successful under the proposed ability-to-repay requirements.[101] Lenders have told Pew that external data pulls are costly and create regulatory risk with prudential examiners, and a real-time database would be difficult to integrate with their existing systems, making the feasibility of a small-loan program even more challenging. In contrast, those requirements are easily manageable for payday and auto title lenders that have some appetite for regulatory risk, can integrate products from vendors designed to make them compliant with the rulemaking, do not face prudential regulator supervision, and are willing to charge high prices to customers.

[101] Most interviewed bank and credit union executives expressed such deep misgivings about the proposed ability-to-repay process that they would not even attempt to make loans available under it, while a couple indicated they might try even though they highly doubted their ability to succeed. A few executives contemplated trying it even though they expected to fail and expressed hope that this would convince regulators of the need to revise their rules to include a simplified compliance option that would better meet the needs of banks and their customers.

A well-designed conditional exemption such as the 5 percent payment-to-income ratio alternative discussed in Section 6 of this letter would alleviate these problems by setting clear standards for lower cost market competitors including banks and credit unions. A viable, consumer-friendly conditional exemption that banks and credit unions could utilize—at a scale sufficient to reach millions of borrowers—would be likely to produce more consumer benefit than the entirety of the Bureau's proposed rule.[102] This would greatly strengthen the rationale for this rulemaking under Section 1022(b) of Dodd-Frank because the benefit to consumers of the current proposed rule is likely to be small, making the cost-benefit analysis in justifying the rulemaking less than clear-cut. (See Section 5 of this letter for discussion.) Numerous stakeholders, including bank and credit union executives, have expressed support for this approach. (See Section 6 of this letter for discussion and Appendices G, H, and I for selected stakeholder views.)

As a result, if the proposed rule fails to include a viable conditional exemption for lower-cost loans at scale from banks and credit unions, it would be likely to reduce the availability of lower-cost credit.

ii. Existing lower-cost programs from small banks and credit unions insufficient to provide broad consumer benefit; rule puts some in jeopardy

Banks and credit unions generally have avoided providing payday loan alternatives,[103] but there are some low-volume programs available, particularly from smaller depository institutions. The Bureau provided a conditional exemption to the ability-to-repay rule designed to help protect the largest of these programs, the National Credit Union Association's Payday Alternative Loan (PAL) program. While this is typically a lower-cost and safe option for borrowers, we note that this is a very low-volume program. Data from 2015 show fewer than 200,000 PAL loans were issued by all participating credit unions (compared to roughly 100 million payday loans offered that year).[104] The Bureau's new rule will not help this program to scale or lead other lenders to use this section to scale lower-cost products; it is simply protecting an already existing program that does not provide lenders with the revenue and automation needed to compete in the market.

The proposed rulemaking would jeopardize altogether two lower-cost small-dollar loan programs from credit unions that have achieved some scale. The StretchPay program

[102] As we explain elsewhere in Section 4 and the Executive Summary of this letter, the proposed rule would bring some consumer benefits, but they would be small compared to the benefits of the option discussed above.

[103] Pew supported OCC and FDIC attempts to limit short-term payday loan-like "deposit advance loans" from proliferating in the market because these loans featured unaffordable balloon payments that drove repeat borrowing to make ends meet. Few banks offered such loans. Most have stayed away from providing affordable small installment loans and a lack of federal guidance about the appropriate way to do so is a leading reason for that.

[104] National Credit Union Administration, *Trends and Estimates of Consumer Savings from Payday Alternative Loan Programs* (2015), 10, https://occ.gov/topics/bank-operations/innovation/comment-pew.pdf#page=10.

offered by many Midwestern credit unions would likely be discontinued under the proposed rules,[105] as would Kinecta Federal Credit Union's Payday Payoff Loan Program.[106]

The Bureau's rule will jeopardize the availability of other low-volume programs, particularly at small banks and credit unions that sometimes provide small loans to known customers on an ad hoc basis. The Bureau's proposed "portfolio default rate" exemption will fail to preserve these programs. It would also condone practices that are not consumer friendly and are even dangerous, and should be replaced with a volume-based alternative. (See Section 6(b)(i) and 6(b)(ii) of this letter for discussion.)

In sum, without modifications, the proposed rule would be likely to reduce the availability of credit from small banks and credit unions, while it would make it difficult or impossible for banks generally to enter the market with lower-cost products at large scale.

(d) Proposed rule would likely shift borrowers from high-cost 2-week and 1-month loans to installment versions of these loans at similar interest rates

i. High-cost lenders will operate primarily under the longer-term ability-to-repay section, not under the conditional exemptions

Because the longer-term ability-to-repay section of the rule is likely to be by far the most profitable for payday and auto title lenders, they are almost certain to primarily operate under that part of the proposed rule. That section would enable lenders to offer customers who currently use payday and auto title loans similarly high-interest loans, just with longer terms to reduce the loans' monthly payments. Because most current payday and auto title loan customers are projected to pass the ability-to-repay test for some amount, they will continue to receive high-interest loans in most states. Today an average payday loan borrowers receives a $375 loan and has it out for five months of the year, paying $520 in finance charges.[107] Under the proposal, the same borrower could receive the same $375 loan, and pay it off in installments over five months of the year for $520 in finance charges.

While the proposed rule includes three conditional exemptions, payday and auto title lenders can earn far more money by issuing longer-term ability-to-repay loans, so these lenders are likely to make little use of the three proposed conditional exemptions. None of the

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[105] Douglas Fecher, "President's Message—Small-Dollar Lending: WPCU Fights for Members," Aug. 2016, http://www.wpcu.coop/eNews2016-august/presidents_message.aspx.
[106] Luis Peralta, "Threading the Needle on Payday Loan Regulation," *Credit Union Times*, Aug. 29, 2016, http://www.cutimes.com/2016/08/29/threading-the-needle-on-payday-loan-regulation.
[107] The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 4, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/pewpaydaylendingreportpdf.pdf#page=6.

conditional exemptions would support small-dollar loans at scale from banks, credit unions, or other lower-cost providers, so the very large majority of loans on the market would be longer-term ability-to-repay installment loans and lines of credit issued by payday and auto title lenders.[108] A relatively small number of NCUA PAL loans are likely to be issued under Section 1041.11 of the proposal, but fewer than 200,000 of these loans were issued in 2015 (in contrast with roughly 100 million payday loans), and that number is likely to rise only modestly, if at all.[109]

ii. Projected credit reductions fail to recognize shift to multi-payment loans

Projections for the decline in payday loan volume from the Bureau and several industry analysts examine only the short-term side of the rule, meaning the impact of the rule on single-payment loans. The volume of these loans is almost certain to shrink dramatically, but the availability of high-cost credit is unlikely to experience a large decline as lenders shift from single-payment to multi-payment loans. In most states, lenders will continue to replace single-payment loans with installment loans and lines of credit. This shift has already begun in many states, such as Illinois, New Mexico, Ohio, Texas, Virginia, Wisconsin, and others. Lenders in these states easily transitioned from offering single-payment loans to primarily offering multi-payment loans. In 2012, 27 percent of Texas' payday loans were structured to be repaid in installments, while that figure rose to 67 percent by 2015.[110] The annual percentage rates for these loans did not decline, and it is unclear whether installment loans with large payments and annual percentage rates above 400 percent are less harmful to consumers than otherwise similar single-payment loans.

Because this shift is in fact well underway, the Bureau's estimates of the costs to lenders of making this shift seem overstated (the Bureau writes, "Lenders who do not currently offer longer-term products but decide to expand their product range would incur a number of costs. These would include learning about or developing those products; developing the policies, procedures, and systems required to originate and service the loans; training staff about the new products; and, communicating the new product offerings to existing payday and single-payment vehicle title borrowers.")

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[108] The Pew Charitable Trusts, "An analysis of the draft rule: The CFPB's Proposed Payday Loan Regulations Would Leave Consumers Vulnerable" (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

[109] National Credit Union Administration, *Trends and Estimates of Consumer Savings from Payday Alternative Loan Programs* (2015), 10, https://occ.gov/topics/bank-operations/innovation/comment-pew.pdf#page=10.

[110] Texas Office of Consumer Credit Commissioner, *Credit Access Business (CAB) Annual Data Report* (2012), http://occc.texas.gov/sites/default/files/uploads/misc/cab-annual-2012.pdf; Texas Office of Consumer Credit Commissioner, *Credit Access Business (CAB) Annual Data Report* (2015), http://occc.texas.gov/sites/default/files/uploads/reports/cab-annual-2015.pdf.

(e) Summary: How the market impact of a revised CFPB rule could be strongly positive if improvements are made

In sum, under the current CFPB proposal, the chief market impacts would be to minimize the availability of credit to very low-income individuals (sub-$1,500 monthly income), and shift the market from 400 percent APR single-payment loans to 400 percent APR multi-payment loans for most other individuals. As discussed in Section 5, that outcome is unlikely to substantially improve consumer well-being. But this is not inevitable. Modifications to the proposed rule discussed in Section 6 could encourage lower-cost beneficial credit, discourage excessive pricing and loan lengths, enable lower-cost loans that would cannibalize usage of higher-cost loans including noncovered forms of expensive credit,[111] and improve borrower welfare immensely.

[111] The rule as proposed does not apply to certain forms of high-cost credit such as pawn, unsecured subprime installment, rent-to-own, and overdraft, nor to late fees. However, the rule if modified could encourage more competition from lower-cost lenders that could provide new alternatives to help consumers save money and achieve better outcomes relative to these other options as well.

5. Analysis: The proposed rule does not adequately respond to harmful practices in this market nor provide sufficient consumer benefit

In this section, we focus primarily on the limitations inherent to the ability-to-repay proposal and discuss the negative implications this could have with respect to consumer well-being and the Bureau's ability to withstand legal challenges from those who oppose reform.

(a) The fundamental problem with covered loans is the leveraged payment mechanism, which creates greater risk of harm than the absence of any particular ability-to-repay analysis

Conventional creditors engage in underwriting to control risk that the borrower will not pay them back. Payday and auto title lenders typically do not engage in conventional underwriting because they use a leveraged payment mechanism as the primary means to control their risk.[112] With the power to reach into borrower checking accounts on payday—often ahead of other creditors—or repossess the borrower's vehicle, lenders of covered loans have greater power to compel repayment than conventional creditors typically have. This gives lenders of covered loans unusually strong ability to control credit losses with relatively less up-front underwriting effort, even when lending to unusually financially fragile borrowers who have damaged credit histories.[113]

As explained below, it is Pew's analysis that the core problem the Bureau must address with respect to covered loans is the inherently dangerous nature of the leveraged payment mechanism, and that in choosing to mandate a *process of underwriting loans* without placing limits on the *use of leveraged payment mechanisms*, and safeguards to minimize their danger, the CFPB has failed to address the harms adequately or articulate a regulatory approach that will sufficiently benefit consumers.

(b) The leveraged payment mechanism is inherently risky to consumers

By definition, covered loans are those where the borrower is unusually vulnerable (willing to take a loan even at abnormally high rates) and the lender is unusually powerful (able to compel

[112] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 26, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=32 Lenders of covered loans need to control for risk of fraud. Online lenders have developed sophisticated solutions to control fraud associated with lending to unknown customers over the internet (see *The Pew Charitable Trusts, Fraud and Abuse Online: Harmful Practices in Internet Payday Lending* (2014), http://www.pewtrusts.org/~/media/assets/2014/10/payday-lending-report/fraud_and_abuse_online_harmful_practices_in_internet_payday_lending.pdf). But for controlling risk of credit losses—ensuring that legitimate borrowers will repay the loans—the leveraged payment mechanism is the primary tool throughout the covered loan market.

[113] We discuss the unusually strong leverage of lenders and unusually financially fragile condition of borrowers in the covered loan market in Sections 3(b) and 3(c).

repayment using the leveraged payment mechanism).[114] Even the *threat* of exercising this leveraged payment mechanism is sufficient to convince borrowers of payday or auto title loans to pay the lender even if doing so undermines the borrower's ability to pay other bills or meet other personal or family needs.[115] As long as lenders retain the ability to reach into borrowers' checking accounts or repossess vehicles in association with high-cost loans, the relationship between borrower and lender will inherently be an asymmetric one and consumers will be at risk of abuse.[116]

The risk posed by the leveraged payment mechanism in combination with a high APR warrants regulation, demonstrating the need for clear safeguards as a counterbalance to this risk. Desperate to get help paying bills, living in circumstances where work schedules often fluctuate and income is volatile, where making ends meet is often a struggle and low credit scores make borrowing from conventional lenders difficult or impossible, those who borrow covered loans have little ability to protect themselves when lenders abuse or threaten to abuse the leveraged payment mechanism. (See Section 3 of this letter for discussion of research and analysis of borrowers.)

(c) Banning the leveraged payment is not a viable option

Though the leveraged payment mechanism is inherently dangerous, it is also the necessary tool that makes it possible for lenders to extend credit to consumers with damaged credit histories. Payday loan borrowers are primarily "thick file" consumers who have missed bill payments or struggled with conventional credit in the past, and the typical payday loan applicant has a FICO credit score in the low 500s.[117] Such a low credit score means, by definition, that the borrower presents a substantially elevated risk of defaulting on a loan compared to prime borrowers.[118] That explains why conventional creditors will no longer extend loans to consumers whose credit scores drop so low: Without a leveraged payment mechanism to help compel repayment, credit losses on such loans would be unmanageable.

Banning the leveraged payment mechanism would likely eliminate payday, auto title, and similar types of covered loans. While some policy makers might reasonably choose to do that, the

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[114] Id.

[115] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 40-42, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=46 The Pew Charitable Trusts, *Auto Title Loans: Market practices and borrowers' experiences* (2015), 13, http://www.pewtrusts.org/~/media/assets/2015/03/autotitleloansreport.pdf#page=17.

[116] This abuse would include, but would not necessarily be limited to, lenders taking "unreasonable advantage" of "the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service" as defined at 12 U.S.C. 5531(d)(2)(B).

[117] Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, http://dx.doi.org/10.2139/ssrn.2160947. See also Section 3(a) for discussion of borrower profile.

[118] See, e.g., VantageScore, Credit Score Basics, Part 1: What's Behind Credit Scores? (2011), http://www.transunion.com/docs/rev/business/financialservices/VantageScore_CreditScoreBasics-Part1.pdf.

Bureau has chosen a different approach (and is unlikely to have the power to ban covered loans anyway).[119] Instead, the Bureau's task is to regulate how these loans are provided. Regulating the market for covered loans requires imposing sufficiently strong safeguards to achieve a proper balance between the benefits associated with allowing lenders to use leveraged payment mechanisms (i.e., providing loans to consumers who have damaged credit histories) and the inherent consumer risk involved in giving lenders such control over these borrowers' checking accounts or vehicle titles. As explained below, the rule as proposed falls short of that goal and should be revised.

(d) The proposed "ability-to-repay" rules do not adequately address the core harms presented by the leveraged payment mechanism

As the Bureau has noted repeatedly, too many lenders of covered loans rely on their ability to collect without respect to the borrower's ability to repay.[120] Yet the Bureau seems to assume that requiring lenders to follow a process of evaluating an applicant's financial condition and estimating certain expenses will somehow eliminate this problem or result in better outcomes for consumers. As long as lenders have access to leveraged payment mechanisms, they will have unusually strong ability to collect on loans regardless of the underlying financial condition of the borrower, and there is little evidence that requiring lenders to follow the mandated ability-to-repay process will prevent them from abusing the leveraged payment mechanism (and as we have noted in Section 4 of this letter, it may not yield substantially better consumer outcomes overall).

Further, as discussed below, the Bureau has not articulated clear benchmarks that supervisory staff or others could use to differentiate affordable loans from unaffordable loans in evaluating whether the lender made a "reasonable determination" when underwriting the loan. Yet payday and auto title lenders have already shifted toward issuing installment loans and lines of credit for which most applicants will qualify under the CFPB's ability-to-repay standard even though the loans require monthly payments that most borrowers would find unaffordable and feature unreasonably long repayment periods and other harmful terms.[121] Lenders can easily lower payments and extend terms for applicants who come up somewhat short under this proposed test.

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[119] The entire rule is designed to govern only loans that last less than 45 days and longer-term high-cost loans that include leveraged payment mechanisms. By making the leveraged payment mechanism part of the definition of a covered longer-term loan, the Bureau has recognized the potential harm inherent in that device, but it has chosen to permit loans with leveraged payment mechanisms as long as lenders follow certain rules intended to mitigate such harms. The Bureau, industry analysts, and Pew anticipate that longer-term covered loans will remain widely available on the market (see Section 4 of this letter).

[120] See, e.g., 81 F.R. 47987 and 47996.

[121] The Pew Charitable Trusts, "From Payday to Small Installment Loans" (2016), 7, http://www.pewtrusts.org/~/media/assets/2016/08/from_payday_to_small_installment_loans.pdf#page=7. See also Section 4 of this letter for discussion of likely market developments under the proposed CFPB rule.

Without the true risk of loss to motivate fair underwriting, lenders of covered loans will naturally execute any regulator-mandated ability-to-repay test in a way that meets minimal compliance requirements while maximizing their profitability—and often abusing borrowers in the process. In other words, as long as the leveraged payment mechanism is available, high-cost lenders will not be subject to the incentives necessary for motivating them to underwrite loans in a way that is fair to consumers.[122]

Consequently, even under the CFPB's proposal to mandate a process for assessing ability to repay, borrowers will remain exposed to harm. That is why Pew strongly encourages the Bureau to supplement its "underwriting-only" approach with clear product safety standards to ensure affordable payments and reasonable time to repay. (See Section 6 of this letter.)

(e) Even by the CFPB's account, it is virtually impossible to estimate a loan applicant's financial condition in a manner that is adequate to offset the risk of harm posed by the leveraged payment mechanism through an underwriting-only approach

The CFPB's ability-to-repay process would require lenders to assess applicants by verifying income, identifying debt obligations in a "national consumer report" from a conventional consumer credit reporting agency, reviewing borrowing history of covered loans in a yet-to-be-created information system that is registered with the Bureau, and estimating certain expenses.[123] Based on this information, lenders would be required to make a "reasonable determination" that the applicant will be able to repay the loan according to its terms. This formula requires no verification of expenses that are not shown on the national consumer report, and as the Bureau notes, "lenders would need to *estimate* an amount that borrowers generally need for basic living expenses" and could satisfy this requirement by "*using available estimates published by third parties*" (emphasis added).[124]

[122] While we support the Bureau's proposal to limit how many times a lender may electronically debit a borrower's checking account before having to obtain new authorization to do so again, this would not constitute a holistic approach to alleviating the harm or risk associated with leveraged payment mechanisms. It is clear from today's market that even the *threat* of cashing a check, debiting an account electronically, or repossessing a vehicle is sufficient to compel many consumers to repay or renew the covered loan even though it undermines their ability to pay other bills or meet other obligations (see footnote 115).

[123] We say "mandated ability-to-repay process" to denote that the CFPB is proposing to require a very specific method for underwriting loans, followed by a requirement to make a "reasonable determination," rather than imposing a more generalized requirement to underwrite loans reasonably. As we note in our discussion of the proposed 5 percent payment-to-ratio income alternative (Section 6 of this letter), it would be appropriate to expect lenders to establish their own reasonable methods for underwriting and originating loans provided these loans include the much stronger consumer protections found in a conditional exemption such as the 5 percent payment-to-income ratio alternative.

[124] 81 F.R. 48135. The Bureau also notes that lenders could instead choose to estimate needed basic living expenses by "providing for a 'cushion' calculated as a percentage of income" or by "collecting information directly from applicants," presumably by asking applicants to fill out a form estimating their own needs.

This is an inadequate approach that could falsely appear to add significant consumer protections while leaving lenders that use leveraged payment mechanisms far too much leeway to justify unaffordable payments or other harmful lending practices by reference to imprecise estimates that may appear reasonable for average consumers but are in fact grossly inadequate for any given applicant. For example, if a payday loan applicant spends 47 percent of income on rent, but consumers with similar incomes in that market spend 30 percent of income on rent, the lender is free to use the 30 percent figure to underwrite the loan.

It is notable that applicants for covered loans experience enormous heterogeneity in their budgets. For example, the Domestic Policy Council has noted that the lowest-income quintile of households with at least one infant spend 14 percent of income on diapers.[125] Some applicants with multiple children will spend a large share of income on child care and are likely to have little residual income. New America has found that "the average cost of full-time care in child care centers for all children ages 0-4 in the United States is $9,589 a year, higher than the average cost of in-state college tuition ($9,410)."[126] For an average payday loan borrower earning about $30,000 per year, this expenditure would represent 32 percent of income. Of course this figure would be much higher for an average borrower with multiple children. This expense would not be included on a credit report. Others spend a large share of income on student loan payments, which would be included on a credit report. If these people are typical payday loan customers, they can only afford payments of $125 or so per month while covering basic expenses. (See Section 3(a) of this letter for discussion). But they will look quite different from each other in the ability-to-repay analysis, where the applicant with child care expenses will appear to be able to afford a very large payment, and the applicant with student loan payments will not—*when in fact, neither one could*.

As the Bureau acknowledges repeatedly in its proposal, data about living expenses are crude and in short supply, and available data do not adequately describe any given individual's actual living expenses with any degree of certainty. The Bureau notes that "[d]ata on major financial obligations and basic living expense are only available at the household level, and only for certain obligations and expenses," and finds that "[g]iven the limited information on major financial obligations and basic living expenses it is likely the case that estimates made using the available data will overstate the share of borrowers who would demonstrate an ability to repay

[125] Cecilia Muñoz, "The Diaper Divide," *White House Blog*, March 10, 2016, https://www.whitehouse.gov/blog/2016/03/10/diaper-divide. Cecilia Muñoz is the Assistant to the President and Director of the Domestic Policy Council.
[126] Brigid Schulte and Alieza Durana, *The New America Care Report* (2016), https://www.newamerica.org/better-life-lab/policy-papers/new-america-care-report/.

a payday loan."[127] Consequently, the Bureau concluded that "estimating the share of borrowers who would be likely to demonstrate an ability to repay the loan is very challenging."[128]

This same dynamic will work in favor of lenders that would abuse the leveraged payment mechanism while claiming compliance with the Bureau's ability-to-repay requirement. If the Bureau is unable to create accurate estimates of potential borrowers' residual income or capacity to make payments on covered loans, it is also going to struggle to differentiate between reasonable underwriting and unreasonable underwriting in the context of the proposed ability-to-repay standard for covered loans. Lenders, meanwhile, will claim that they made reasonable estimates and will challenge the Bureau to prove otherwise, which will be difficult or impossible for the Bureau to do in many cases. (It is for these reasons that Pew urges the Bureau to include clearer product safety standards with the ability-to-repay rule and instruct its examiners to give heightened scrutiny to loan portfolios with elevated default rates, per the discussion in Section 6 of this letter below.)

To help illustrate this point, we refer to the example given at 81 F.R. 48123, in which the Bureau contemplates an applicant whose household income is between $2,000 to $2,499 (see Table 3 below, copied from the Notice of Proposed Rulemaking at 81 F.R. 48123 and modified to eliminate original page breaks and to highlight the given example). This example reflects a borrower with somewhat lower income than average (the average borrower's income is about $2,500 per month).[129]

TABLE 3—DISTRIBUTION OF HOUSEHOLD EXPENDITURES AND AVERAGE REMAINING INCOME BY HOUSEHOLD MONTHLY INCOME [a]

Household monthly income	Total household expenditures [a]				Recurring obligations [b]	Basic living expenses [c]	Remaining income
	Mean	10th Pct.	Median	90th Pct.	Mean	Mean	Mean
$0-$499	$1,096	$432	$982	$1,888	$555	$541	$−884
$500-$999	971	428	879	1,641	451	520	−190
$1000-$1499	1,196	595	1,094	1,958	589	607	36
$1500-$1999	1,383	732	1,280	2,156	673	710	350
$2000-$2499	1,519	888	1,450	2,281	756	763	689
$2500-$2999	1,674	1,002	1,557	2,461	870	804	1,062
$3000-$3499	1,743	1,066	1,667	2,617	901	843	1,459
$3500-$3999	1,854	1,157	1,743	2,736	975	880	1,864
$4000-$4999	2,011	1,218	1,900	2,981	1,052	959	2,436
$5000-$5999	2,186	1,342	2,087	3,152	1,189	997	3,260
$6000-$6999	2,325	1,471	2,227	3,359	1,283	1,042	4,112
$7000-$7999	2,580	1,650	2,500	3,735	1,453	1,128	4,841
$8000-$8999	2,760	1,709	2,656	4,017	1,551	1,209	5,668
$9000-$9999	2,855	1,801	2,824	4,188	1,576	1,279	6,547
$10,000+	3,182	2,014	3,108	4,652	1,819	1,363	9,562

Source: 2010 BLS Consumer Expenditure Survey.
[a] Household expenditures include housing obligations (rent or mortgage payments), vehicle loan payments, expenditure on transportation (gas and public transit), payments on utilities, and expenditure on food.
[b] Recurring obligations include housing obligations (rent or mortgage payments) and vehicle loan payments.
[c] Basic living expenses include expenditure on transportation (gas and public transit), payments on utilities, and expenditure on food.

[127] 81 F.R. 48122. The Bureau added: "In addition, only some of the obligation and expense data is available specifically for payday borrowers, and in no case is the obligation or expense data tied to specific loans." While this particular discussion is about short-term covered loans, the Bureau notes (at 81 F.R. 48137) that it also applies to longer-term covered loans.
[128] 81 F.R. 48137.
[129] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 53, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=59

Source: 81 F.R. 48123 to 48124.

In this example, the Bureau notes the average recurring obligations (for housing and vehicle payments) and basic living expenses (for gas, public transit, utilities, and food), and concludes: "That leaves $689 [of "remaining income"] to cover any other major financial obligations, including payments on other forms of debt, and other basic living expenses."[130]

The problem with this analysis is that it is so rudimentary that it neither provides adequate consumer protection against harmful practices nor gives even scrupulous lenders sufficiently clear guidance on how to properly and fairly structure covered loans. This would be doubly bad for consumers. In the example above, the applicant's available remaining income could differ from published estimates by well more than 100 percent. If, for instance, the applicant makes $2,499 monthly and has actual total household expenditures at the 10th percentile level ($888), then remaining income would be $1,611 ($922—or 134 percent—higher than the average). Conversely, if this applicant's actual expenses were at the 90th percentile level ($2,281), then remaining income would be $218 ($471—or 68 percent—lower than the average). In this example alone, a lender would have the option of choosing to base its estimate of the appropriate monthly loan payment somewhere between $218 at the low end, $689 using published averages, or $1,611 at the high end—minus whatever other debt obligations may be revealed on the applicant's credit reports (such as credit card monthly minimum payments) and whatever the lender chooses to estimate for "other living expenses."[131]

For a given borrower in this income range, who is already struggling financially to the point of seeking out a high-cost covered loan (typically, to get help paying regular bills), the potential monthly payment could be anywhere between about $200 more than $1,500. This would obviously leave too many borrowers exposed to unaffordable payments. Further: assuming a borrower making $2,250 per month with $689 in remaining income (representing the middle baseline income and average remaining income, respectively, in the CFPB's example) the allowable payday loan payment could consume more than 30 percent of the borrower's monthly paycheck. Clearly, this would not be affordable for typical payday loan borrowers, who according to a variety of research can only afford to pay about 5 percent of their paychecks

[130] 81 F.R. 41823. "Other basic living expenses" is not defined.

[131] Neil Bhutta, Paige Marta Skiba, and Jeremy Tobacman, *Payday Loan Choices and Consequences*, Oct. 11, 2012, Vanderbilt Law and Economics Research Paper No. 12-30, http://dx.doi.org/10.2139/ssrn.2160947. "Other debt" shown on an applicant's credit report—such as credit card or student loan debt—would reduce the amount of "remaining income" available for a new payday loan. But, for most applicants, the reduction in payment size would not be large. The most likely "other debt" to appear on an applicant's credit report would be credit card debt, since a majority of payday loan borrowers carry credit card debt. However, assuming a payday loan borrower's average credit card balance of $3,287 (per the Survey of Consumer Finances as cited by the CFPB at 81 F.R. 48124, Table 4), this would reduce the calculation of "remaining income" available for a new covered loan payment by only about $100 (assuming a 24 percent APR on the credit card and a typical minimum required payment equal to monthly interest plus one percent of principal).

toward a loan while still meeting other obligations.[132] This would hardly be an improvement on today's market, where typical payday loans take 36 percent of a borrower's paycheck, causing consumer harm that the lender is insulated from since the loan is secured by a leveraged payment mechanism.[133]

- Imposing such monthly payments would be indefensible from the perspective of achieving true affordability or fairness, yet the Bureau would seem to condone it. Most borrowers would experience difficulty meeting other financial obligations if faced with loan payment such as those in the given examples.

- Given this wide latitude, lenders that tend to rely on the leveraged payment mechanism today to ensure their "ability to collect" even when borrowers may in fact lack the "ability to repay"—one of the core problems the CFPB has set out to address—would hardly be prevented from continuing to abuse borrowers even under the proposed rule. Further, as discussed below, the CFPB will most certainly struggle to stop lenders from abusing this flexibility in the rule because of the lack of clear standards to help examiners identify violations and overly aggressive lending practices.

- Conversely, other lenders such as banks and credit unions will be discouraged by the lack of clear guidelines and associated compliance costs and legal risks of such vague standards.[134] And any mainstream lender that did find a way to make a loan under this ability-to-repay standard would need to pass on the operational and regulatory compliance costs to consumers, and might end up issuing unaffordable loans due to the lack of clear standards.[135]

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[132] A variety of research shows that typical borrowers can afford no more than about $100-$125 per month toward a loan while still making ends meet. See Section 3(a) of this letter for discussion of what payday loan borrowers can afford and why they use the loans. For a summary of research supporting the 5 percent payment standard, see Appendix C.

[133] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 31, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=37

[134] See, e.g., Neil Hall, "Banks Should Lead the Way to More Small-Dollar Loans," *American Banker*, Sept. 13, 2016, and discussion in Section 4 and elsewhere in this letter.

[135] The Bureau's argument (at 81 F.R. 48125 to 48126) that the costs imposed by the ability-to-repay compliance process are not likely to be passed on to consumers because lenders already charge the maximum amount allowed by law is not persuasive in many cases, including in at least eight states where payday lenders operate legally without any price restrictions and the growing number of states where payday and auto title lenders are operating under Credit Services Organization, consumer finance, or open-ended statutes that effectively allow unlimited interest or fees. This would also be true in any state that raises applicable price limits in response to the CFPB's rulemaking. Further, in the case of depository lenders (such as the example discussed above), the Bureau's argument breaks down almost completely. Most banks and many credit unions operate well below legally allowed price limits or are not subject to any legal price limit. Added compliance costs would likely be passed on to consumers in these cases, or would undermine the business case for providing small loans in the first place.

- Meanwhile, millions of consumers will continue to be exposed to harmful loans with unaffordable payments and unnecessarily high costs, and will miss the opportunity to save billions of dollars by obtaining safer forms of alternative credit from lower-cost mainstream lenders such as the banks and credit unions where they already hold checking accounts.[136]

(f) Ongoing harms may be difficult or impossible to detect through regulatory examination, making an underwriting-only approach insufficient

The Bureau assumes that lenders will choose to automate the process of estimating applicants' housing expenses,[137] and seems to anticipate that lenders will use average costs as the basis for their calculations.[138] This is probably correct.[139] Yet given the near impossibility of using aggregate data to estimate an individual borrower's actual financial capacity accurately, the Bureau will have little basis for distinguishing between "reasonable" underwriting (resulting in appropriate loans) and "unreasonable" underwriting (resulting in inappropriate or harmful loans).

When lenders provide inappropriate or harmful loans yet retain the leveraged payment mechanism to secure repayment, it will negatively impact borrowers, but these impacts will be difficult or impossible to detect through examination or enforcement efforts.

- This is reflected in the fact that conventional payday loan portfolios today give the appearance of having low default rates (averaging approximately 3 percent of loans) even though the loans undermine borrowers' ability to make ends meet without having to borrow again. Though Pew recommends (in Section 6) applying heightened scrutiny to any loan portfolio in which greater than 10 percent of loans default, we also note that default rates are not by themselves dispositive of the quality of underwriting, especially in subprime credit markets (in which borrowers have damaged credit histories and are by definition more likely to default than mainstream borrowers due to a variety of factors) and in cases where high-cost lenders have leveraged

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[136] See discussion in Section 4 of this letter. For more of Pew's commentary on this point, see: http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

[137] See, e.g., 81 F.R. 48119

[138] See, e.g., 81 F.R. 48123 to 41824 (the Bureau gives example calculations using average expenditure and remaining income estimates from the Consumer Expenditure Survey).

[139] Automation will be an essential component of any successful business model in this space and payday loan servicers are already advertising automated solutions for simplifying compliance with CFPB ability-to-repay rules. See, e.g., Microbilt Corporation, http://www.microbilt.com/product/instant-bank-verification; FactorTrust, "Factortrust Offers Advanced Lendprotect ATR Solution To Better Assess Ability To Repay," May 17, 2016, http://ws.factortrust.com/2016/05/17/factortrust-offers-advanced-lendprotect-atr-solution-to-better-assess-ability-to-repay/.

payment mechanisms that allow them to enforce an ability to collect on unaffordable loans. (See Section 3(f)(iv) of this letter for discussion of default rates.)

- Missing payments on formal debt obligations such as mortgages or car payments may not show up on consumer credit reports until months have passed.

- When covered loans cause hardship that leads borrowers to miss payments on other obligations, it may never show up on credit reports. Missed payments on rent and utilities, for example, may ultimately lead to eviction or loss of service but often do not show up on consumer credit reports.

- Other harmful effects are not detectable through any conventional reporting mechanism: poor nutrition, diminished ability to care for a child, diminished career prospects or loss of job, psychological distress, relationship or family problems, disruptions in ability to save, putting off important maintenance of car or home, and so on. In 22 focus groups that Pew organized in recent years, borrowers conveyed a variety of hardships caused by unaffordable loan payments, from having to skip meals to not being able to meet children's basic needs. As a borrower in one focus group said, "As much as I would just like to say, 'Here's the $300, I'm good. I don't want another loan,' I can't. Because if I do, that $255 that I don't have, what am I going to do? That's anything from like rent, other bills, food, cost of living stuff. It's difficult."[140]

Even with evidence of any of these negative outcomes, establishing a causal relationship between usage of a covered loan and defaulting on other obligations or other harmful outcomes will be difficult for examiners in any particular case, particularly because borrowers of covered loans already have turbulent finances and volatile incomes. (See Appendix F.) This is another reason why it would make sense for the CFPB to target the inherent consumer risks associated with the leveraged payment mechanism with stronger and more direct regulations (see recommendations in Section 6 of this letter).

(g) Without the recommended improvements to the rule, the benefit to consumers is tenuous and the Bureau will incur legal risk

[140] The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 16, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-(1).pdf#page=16.

Regulatory examiners will struggle to be effective under this system, and will ultimately be faced with a choice between prohibiting most forms of covered loans or allowing most forms of covered loans (even though many or most will have unaffordable high monthly payments and overly long or costly repayment periods). The CFPB has made it clear that it does not intend to cut off access to credit in this market, and so there is likely to continue to be a flood of high-cost installment loans in the years ahead.[141] Yet the Bureau has given itself and regulatory examiners generally few tools or benchmarks for distinguishing between high-quality and low-quality loans, or between more reasonable and less reasonable methods of determining a consumer's ability to repay, and this leaves enforcement options essentially limited to seeking out the most egregious or deceptive practices that somehow stand out from the rest. This will leave too many consumers exposed to harm.

The Bureau's statement in its Dodd-Frank Act Section 1022(b)(2) analysis that the mandated ability-to-repay process will benefit consumers "by reducing the harm they suffer from the costs of delinquency and default on longer-term loans [and] from the cost of defaulting on other major financial obligations or being unable to cover basic living expenses in order to pay off covered longer-term loans"[142] is not persuasive considering the Bureau's unnecessarily heavy reliance on a *mandated process* of evaluating a borrower's financial condition without reference to *clear product safety standards* or limits on the use of inherently risky leveraged payment mechanisms; the Bureau's own concerns about the lack of available data for effectively conducting the proposed ability-to-repay process (e.g., the lack of data for accurately estimating an individual's actual living expenses); the Bureau's apparent acceptance under the ability-to-repay test of monthly payments that are three-times or more greater than what research shows borrowers can actually afford; and the other concerns noted above.

While Pew has consistently called for payday loan reform, and has supported the Bureau's efforts and found that certain benefits would arise from imposing ability-to-repay standards,[143] we are extremely concerned that the ability-to-repay standard as proposed is so vague and subject to abuse by lenders using leveraged payment mechanisms, and so lacking in clear guidelines that would be necessary to ensure better consumer outcomes, that it leaves consumers extremely vulnerable and makes the Bureau's claims about the benefits of the ability-to-repay standard subject to successful attack by opponents of regulation. Further, as Pew has explained in Sections 4 and 6 of this letter and elsewhere, in addition to leaving borrowers vulnerable as proposed, unless it is revised to include the Bureau's proposed "5

[141] As noted above in this Section, the CFPB's proposal would allow for unaffordable payments and other harmful practices that would be difficult to stop through enforcement actions. See Section 4 of this letter for additional discussion of likely market outcomes.
[142] 81 F.R. 48139
[143] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 26-38, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=32 Creating an environment where most covered loans are installment loans repayable over time is the necessary first step toward correcting the harms in this market, but additional requirements are required to ensure successful installment loan markets.

percent payment-to-income ratio alternative" the Bureau's rule will miss the rare chance to save these struggling borrowers billions of dollars by enabling more competition from mainstream lenders offering lower-cost loan alternatives.[144]

Under the rule as proposed, consumers are at grave risk of facing similar harms and paying similar or even higher costs compared to today. The CFPB has been unable to show that the mandated ability-to-repay process alone will address the harms in this market in a way that will consistently or even frequently lead to truly affordable payments or give borrowers a reasonable time to repay, nor do much to save consumers money; but this could easily be corrected by setting firmer product safety standards and making other adjustments to the rule to better protect consumers, on the one hand, and by implementing the "5 percent payment-to-income ratio alternative" to increase the likelihood of more competition from mainstream lenders providing loans according to clear rules that limit the size of monthly payments, ensure a reasonable time to repay, and encourage significantly lower cost (see recommendations in Section 6 of this letter).[145]

In short, we urge the CFPB to modify and improve the proposed rule in several key ways in order to more effectively regulate the known harms in the market, better control the inherent risks posed by the leveraged payment mechanism in the context of covered loans, create simplified compliance options for lenders where appropriate to facilitate safer and lower-cost loans at scale from mainstream lenders, and through these changes, greatly improve the benefit to consumers.

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[144] The Pew Charitable Trusts, "An analysis of the draft rule: The CFPB's Proposed Payday Loan Regulations Would Leave Consumers Vulnerable" (2016), http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable. See also Pew's recommendations in Section 6 of this letter.

[145] It is also worth noting that the Bureau is leaving itself unnecessarily exposed to arguments that the burden on lenders is indiscriminate and in some cases excessive. Because of the strategy the CFPB has chosen—with the ability-to-repay process being the primary consumer protection mechanism—it will be necessary to make the core ability-to-repay process *harder* to prevent *predictably harmful practices* in this market; and in turn, this will make it more necessary for the CFPB to provide a streamlined alternative compliance path—the 5 percent payment-to-income ratio alternative—so lenders can profitably provide lower-cost loans at scale. As proposed, the CFPB would impose the same level of burden on lenders without regard to the quality of the loan provided, and this is probably unwarranted (also, the Bureau probably underestimates the burden in time and cost that the ability-to-repay requirements will create for banks and credit unions that could achieve consumer protection goals by relying on checking account data for known customers without having to engage in costly data pulls or complicated residual income analysis). As reflected in Pew's recommendations, the Bureau should provide less burdensome compliance options for lenders making safer or higher-quality loans to consumers, which would better protect consumers and save them money while also decreasing the CFPB's vulnerability to attack from opponents of regulation who would claim that the Bureau is mandating rules that are overly burdensome or fail to provide sufficient consumer benefit to justify the impacts imposed on market participants.

6. Recommended Modifications to the Proposed Rule

Based on our exhaustive research and stakeholder outreach; in the interest of millions of financially struggling households who desire and would benefit from both stronger consumer protections *and* access to better small-loan alternatives; and in the hope of strengthening the CFPB's case for this rulemaking by tailoring its proposal to achieve better consumer outcomes and provide a streamlined (and less burdensome) compliance option for lenders that would like to serve this market according to clear and specific product safety guidelines that would be beneficial to consumers, Pew respectfully recommends that the Bureau modify its rule according to the following recommendations.

Our requests are grouped under two overarching recommendations: (a) Strengthen the proposed ability-to-repay standard to reduce consumer harm; and (b) Eliminate the portfolio default rate conditional exemption and replace it with the 5 percent payment alternative, while adding a *de minimis* exemption for low volumes of accommodation lending.

(a) Strengthen the proposed ability-to-repay standard to reduce consumer harm

The proposed ability-to-repay standard is adequate to address loans with terms of 45 days or shorter because that standard combined with the duration limit will ensure that few people receive such loans. Appropriately, few applicants will pass an affordability test for a loan with a lump-sum payment due in such a short period of time.

However, the proposed ability-to-repay standard is not strong enough or specific enough to reduce consumer harm substantially or generate sufficient consumer benefit with respect to longer-term loans. In this subsection, we recommend that the Bureau more directly regulate leveraged payment mechanisms; or alternatively, adopt other adjustments noted below including making the mandated ability-to-repay standard more stringent in cases where loans are likely to be more dangerous.

i. Establish clear standards to ensure safe and fair use of leveraged payment mechanisms in connection with longer-term covered loans

Pew urges the Bureau to regulate use of leveraged payment mechanisms clearly and directly. For the longer-term ability-to-repay rule to result in safer loans and generate true consumer benefit, it will be necessary to limit both the size of periodic loan payments and loan durations. This could be achieved by prohibiting lenders who hold leveraged payment mechanisms from taking loan payments that exceed a certain percentage of a borrower's monthly income and prohibiting the holding of leveraged payment mechanisms for longer than a certain number of months.

To implement this recommendation, Pew suggests applying the periodic payment and loan duration limits found in the Bureau's previously proposed 5 percent payment-to-income ratio alternative to *all longer-term covered loans*, on the basis that substantial empirical research shows that loans exceeding those thresholds present clear risk of harm to most borrowers, and lenders who use leveraged payment mechanisms should be presumed to be harming most borrowers when they exceed such thresholds.[146] In such cases:

- The Bureau could prohibit lenders from exceeding the stated thresholds altogether; or
- The Bureau could establish a rebuttable presumption that loans exceeding the stated thresholds are harmful, and require lenders to perform more stringent underwriting to overcome the presumption; and/or
- The Bureau could put lenders on notice that they will be subject to heightened scrutiny from regulatory examiners if they exceed such thresholds.

However, should the Bureau choose to impose an ability-to-repay rule without these clear limits on the use of leveraged payment mechanisms, we urge it to modify the rule according to the following recommendations so that loan terms more accurately reflect borrowers' true financial capabilities and harmful lending practices are more strongly discouraged.

ii. Require verification of housing and child care costs.

If clear standards are not provided, a second-best option is to set tighter rules that come closer to ensuring that consumers truly have the ability to repay. Under this scenario, the CFPB should require verification of housing and child care costs.[147] While lenders may utilize different methods of verification, it is important that the Bureau create an expectation that lenders will establish reasonable procedures for identifying and verifying these costs, and examiners can work to ensure that these procedures are sufficient. The

[146] The Bureau described the proposal at 81 F.R. 48040. A summary of key empirical research is found in Appendix C; see also Section 3(f)(i) of this letter for discussion. Note that Pew is recommending formal implementation of the 5 percent payment-to-income ratio alternative below in Section 5(b) of this letter, on the presumption that the Bureau will not apply the standard universally to longer-term covered loans and a streamlined alternative compliance approach will remain necessary. Pew's recommendations for altering the 5 percent payment option in Section 5(b) are specifically tailored for use as a conditional exemption to the ability-to-repay rule.

[147] This would include expenses for daycare or similar programs as well as additional basic living expenses associated with rearing children, such as diapers. Research shows that lower-income households expend large portions of their income on these expenses. For example, The Domestic Policy Council has noted that the lowest-income quintile of households with at least one infant spend an average of 14 percent of income on diapers. Cecilia Muñoz, "The Diaper Divide," *White House Blog*, March 10, 2016, https://www.whitehouse.gov/blog/2016/03/10/diaper-divide. See also Section 5(e) for further discussion.

Bureau has proposed that these and all other expenses not included on a credit report could be estimated or projected instead of verified. This method is likely to result in loans that may be affordable for an average consumer, but in many cases will not be affordable for the loan applicant. Without verification of expenses, it is likely that loan payments under the longer-term ability-to-repay section will frequently be unaffordable. (See Section 5 of this letter for discussion and Appendix E for examples of high-cost payday and auto title installment loans and lines of credit that are already on the market in at least 28 states.)

iii. Ensure that applicants have especially well-documented ability to repay for loans that carry inherently risky terms, such as those where a lender keeps a leveraged payment mechanism for more than six months

A beneficial component of the proposed rule is a requirement to account for income and expense volatility for longer-term ability-to-repay loans. This is an important protection that should be strengthened for loans lasting longer than six months. To ensure ability to repay for these loans, lenders should be required to document income and expenses for as many months in the past as the loan will extend into the future, or ensure that an applicant can withstand a 25 percent decline in income and still afford to repay. A 25 percent change in income is a standard measure of income volatility,[148] and lower-income households are at risk of experiencing such a decline at least once over the course of a loan that lasts longer than six months. (See Appendix F.) For small-dollar amounts, terms longer than six months combined with a leveraged payment mechanism and unlimited costs pose inherent risk to financially fragile consumers. (See Sections 3(b) and 3(f)(v) of this letter.)

iv. Require heightened scrutiny for all loan portfolios that have default rates above 10 percent

The Bureau's proposal currently lacks clear guidelines to help examiners distinguish between loans that pose greater or lesser risk of harm to consumers (or similarly, to identify when lenders are not adequately meeting the requirement to make a "reasonable determination" that borrowers can repay loans according to their stated terms). The 10 percent default threshold for heightened scrutiny proposed here could help examiners make this type of distinction.

[148] Researchers use a variety of measures to define income (individual earnings or household income) and volatility (percent changes in earnings, variance of earnings, standard or deviation of percent changes). For example, when analyzing household income volatility some assess percent changes, including Winship (2011) who looks at those with income declines of 25 percent; Dahl, DeLeire, and Schwabish (2011) who look at those with 50 percent changes in income; Anthony Hannagan and Jonathan Morduch (2015) who look at volatility above or below 25 percent of average income in a 12-month period; and The Pew Charitable Trusts which looks at gains and losses of 25 percent. See Appendix F for further discussion of income volatility.

When lenders do not have a leveraged payment mechanism, such as in the subprime credit card market or traditional installment loan market, default rates are generally less than 10 percent. Ten percent is a reasonable default threshold for consumers with low credit scores when lenders are underwriting for ability to repay rather than ability to collect. Larger banks, community banks, and credit unions have all reported in discussions with Pew that with reasonable underwriting, they expect that *fewer than 10 percent of loans* would default. When lenders rely on ability to collect and do not adequately underwrite loans, as in the current payday installment loan market, default rates are generally more than 10 percent.[149] (See discussion of defaults in Section 3(f)(iv) of this letter for discussion of relevant data).

We make this recommendation with several important caveats:

- It would be appropriate to define *default* for purposes of this threshold as the Bureau has proposed in Section 1041.12 of the draft rule (i.e., charge-off or delinquency of 120 days).

- However, to define *default rate* for purposes of the threshold recommended here, the Bureau should not use the formula in proposed Section 1041.12. The formula found in Section 1041.12 of the proposed rule would produce high apparent default rates because it effectively annualizes losses, while not annualizing dollars lent, and outstanding balances will be less than the total of dollars lent because loan balances decline with principal repayment. This formula would capture far too many safe and reasonably underwritten loans for purposes of the present recommendation.

- Instead, the *share of loans that default* is a reasonable method for identifying when additional examination scrutiny is warranted. For example, if a lender makes 5,000 loans, then the portfolio should face heightened scrutiny if more than 500 of them default. The Bureau could avoid evasion of this standard by establishing that if a loan is refinanced, it would still be counted as one loan for default purposes (so if a borrower refinances a loan three times and defaults after the third refinance, the default rate on that loan would be 100 percent). But if a borrower repays a loan and subsequently takes out a new one, those loans should be counted

[149] Conventional short-term payday loans give the appearance of having low default rates. Default rates appear higher in the market for payday *installment* loans, where more borrowers over time may experience hardships that make repayment difficult, or they may simply experience debt fatigue and abandon their loan payments. We make this recommendation for a default rate threshold not as an absolute measure of the quality or suitability of a loan, but as a benchmark or diagnostic tool to help examiners identify potentially problematic loan portfolios.

separately, so if the second loan defaults, the default rate on those two loans would be 50 percent, not 100 percent. This would fairly account for the fact that borrowers of high-cost loans appear to be naturally motivated to repay loans early when they are able, but some also see value in obtaining additional credit at a later date.[150]

- While default rate is useful as a diagnostic tool for identifying potentially harmful loans, it is too crude to use as an absolute measure to allow or prohibit any type of loan. Well-underwritten loans may not have low default rates when issued to subprime borrowers, because lending to people with low credit scores will usually result in higher defaults than lending to people with prime credit scores. Conversely, poorly underwritten loans can have fairly low default rates, as sometimes happens in the payday and auto title loan markets today where lenders can effectively force repayment of loans before borrowers may choose to pay other expenses. That is why default rate should not be used as an absolute mechanism to judge the quality of loans nor as a means to allow or prohibit certain types of lending, but it can establish a *guidepost to give examiners a tool for identifying loan portfolios that merit additional scrutiny* to ensure that proper underwriting is occurring. Other examination guidelines should bolster this recommendation, but a 10 percent default threshold would communicate an expectation to lenders that default rates consistently above this level or far above this level will raise red flags. By heightened scrutiny we mean that examiners should carefully review the procedures that lenders have established to determine that all consumers truly have the ability to repay, and ensure that lenders are thoroughly accounting for income and expense volatility and factoring all reasonable expenses into their underwriting. Repeatedly high default rates signal that lenders' underwriting is inadequate.

v. Employ stronger restrictions on refinancing longer-term ability-to-repay loans

The Bureau should employ stronger restrictions on refinancing longer-term ability-to-repay loans. Even if the Bureau strengthens the ability-to-repay standard as recommended above, these loans will pose risk of harm to borrowers, and refinancing them will exacerbate that risk. Pew recommends controlling the potential harm associated with

[150] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 14-15, 33-35, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=20 Borrowers can be harmed when lenders have incentive to encourage refinancing or reborrowing as a means to generate large up-front origination fees or mask defaults. Examiners should watch for signs of these dangers.

refinancing by prohibiting origination fees on refinances, requiring a pro rata rebate method upon early repayment, and prohibiting refinances until 75 percent of the loan's balance has been paid down.

(b) Eliminate the portfolio default rate conditional exemption and replace it with the 5 percent payment-to-income ratio alternative, while adding a *de minimis* exemption for low volumes of accommodation lending

In this subsection, we strongly recommend streamlined compliance options to reduce the burden on lenders that agree to abide by reasonable standards set by the Bureau and to improve consumer outcomes. These recommendations would tend to enable providers to offer safer small-dollar loans and benefit consumers by improving their access to safer, lower-cost credit options, thereby strengthening the rule against legal challenges.

i. Eliminate the portfolio default rate conditional exemption

Pew opposes this proposed conditional exemption on grounds that it would condone unacceptable practices and would not help achieve the Bureau's stated goal of enabling small-volume accommodation loan programs at community banks and credit unions. Our concerns include the following:

- The proposed large origination fee, with a safe harbor for $50, misaligns lenders' and borrowers' incentives by frontloading a large share of the loan revenue and effectively penalizing borrowers who repay early or refinance. Spreading costs evenly over the life of the loan would eliminate this consumer harm without impeding lenders' ability to operate profitably.[151] A loan with a monthly fee would be the easiest for consumers to understand, while combining a fee and interest rate introduces complication.

- Further, the restriction of two loans per six months incentivizes consumers to overborrow, discourages them from repaying early if they can afford to, and would drive them outside the banking system after borrowing twice.

- A $50 fee plus 36 percent interest is an excessive cost for a $200, two-month loan, but would probably be insufficient revenue to support a $700, six-month loan. This creates perverse incentives for lenders and could harm consumers.

[151] The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 34-35, 44-45, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/pewpaydaypolicysolutionsoct2013pdf.pdf#page=40

- The 5 percent default rate is also too low to meet the Bureau's stated goal of enabling character or accommodation loans by community banks, both because the draconian penalty for exceeding that threshold (returning all origination fees) puts the viability of the program at risk, but also because the default calculation formula used will generally result in high default rates. The formula (defaulted amounts over the course of the 12-month period divided by average monthly balance outstanding) effectively annualizes the numerator in the equation but not the denominator. The denominator will also be lower than the amount of money lent because it declines as loans are paid off. So a $400, 3-month loan with $16 in losses (4 percent of the amount lent), and an average balance outstanding of $267 (assuming even amortization), would have a portfolio default rate of 24 percent [($16 x 4) / $267]. As a result, this proposed conditional exemption would result in potentially harmful loans if they were issued, but providers are unlikely to be willing to issue them.

ii. Instead, grant a conditional or outright exemption to providers that issue a small volume of loans which represent only a small share of revenue

To achieve the Bureau's goal of preserving ad hoc character loan programs, in which lenders like community banks or credit unions occasionally offer small loans to known customers (sometimes called "character loans"), a simpler and more effective approach would be simply to exempt low-volume loan programs from the rule entirely.

- It is necessary to limit the *number* of loans so that large providers do not use this exemption instead of following the regulations.

- Further, it is necessary to limit the *share of revenue* so that smaller providers only use this exemption if they are truly engaging in accommodation lending rather than a core business line.

- If the Bureau exempts providers that issue no more than 2,000 otherwise-covered loans per year which represent no more than 5 percent of revenue, that should enable existing accommodation lending at community banks and small credit unions to continue without posing substantial risk to the broader rule's efficacy. Feedback Pew has gathered from community banks and smaller credit unions suggests these numbers are viable. If the share of revenue were increased substantially, smaller check-cashers or pawn shops might attempt to create a secondary business line out of these exempted loans.

- This exemption should not be available to lenders that issue short-term covered loans of any kind or longer-term ability-to-repay loans.

iii. Most importantly, restore the 5 percent payment-to-income ratio alternative so that lower-cost loans can replace higher-cost loans *at scale* in a competitive market

For banks and credit unions to offer small loans, they require clear and affirmative regulatory guidance that reduces compliance risk and enables a high degree of automation.[152] Any such guidance should include strong consumer protections to ensure affordable payments, reasonable terms, and lower costs. Because every payday loan borrower has a checking account and income, banks and credit unions are well-positioned to offer these loans at prices six to eight times lower than average payday loans, and closer to ten times lower than payday loans and lines of credit in states where lenders operate without price limits, such as Ohio, Texas, Virginia, and Wisconsin.

Based on extensive engagement with non-profit stakeholders (including civil rights and faith-based organizations, opponents of high-cost lending, proponents of access to mainstream banking and credit services, credit counselors, legal advocates, and social workers) and for-profit stakeholders (including depository and non-depository lenders of all sizes),[153] Pew strongly reiterates the call for implementing the 5 percent payment-to-income ratio and recommends several adjustments in response to stakeholder concerns.

The Bureau noted that some stakeholders raised concerns about the 5 percent payment option. Upon further analysis, we agree that there are several substantive concerns that should be addressed, and the following recommendations should alleviate these concerns while preserving the fundamental value of the 5 percent payment option as a strong consumer protection device and simplified ability-to-repay standard.

<u>**First, to avoid excessive default rates and alleviate concerns that some consumers would be unable to afford loans even with payments limited to 5 percent of borrowers' paychecks and other safeguards, apply heightened scrutiny to portfolios where more**</u>

[152] Pew has written extensively about the benefits of automation, including reduction in loan origination costs that allow lenders to be profitable at a fair price and helping make loans meet competitive consumer demand by enabling fast origination and underwriting methods that prescreen candidates to ensure high rates of loan approval. See "How CFPB Rules Can Encourage Banks and Credit Unions to Offer Lower-Cost Small Loans" in Appendix Z and "Regulators Should Let Banks Get Back to Small-Dollar Loans" in Appendix U.
[153] This includes meeting individually with representatives from numerous banks and credit unions as well as convening group conversations this Summer with executives from 10 of the 15 largest banks in this country. See the summary of Pew's stakeholder outreach in Section 1 of this letter for more information.

than 10 percent of loans default.[154] This would give lenders sufficient incentive to underwrite loans to avoid lending to consumers who lack capacity to take on debt. Further, based on Pew's analysis, a per-loan default rate of no more than 10 percent would be sufficient to allow loan programs that comply with this payment-to-income ratio-based conditional exemption (if designed according to the recommendations here in Section 6(b) of this letter).[155] The Bureau could choose to suspend the rights of lenders that exceed this default threshold to continue using the 5 percent payment-to-income ratio conditional exemption.

Second, to respond to concerns that the Bureau should not appear to condone high-cost loans unless they are subject to the full ability-to-repay test and to enhance the consumer protection value of the 5 percent payment-to-income ratio alternative, limit total loan cost to 50 percent of the amount borrowed. Both consumer advocates and the Bureau have expressed concerns about the inherent harms associated with high-cost loans. For example, The CFPB described in research publications consumers being harmed if they paid more in finance charges during the year than they originally received in principal. This proposed 50 percent cost threshold would address that concern as it relates to loans made under the 5 percent payment to-income-ratio conditional exemption. It would also help achieve stronger protections than the six-month limit the CFPB originally proposed for the 5 percent payment option in its 2015 proposal, and as discussed below this would help respond to lender concerns by safely allowing certain loans to last longer than six months.

In particular, the proposed 50 percent cost limit would avoid the possibility of very small loans that have fees far exceeding loan principal. For example, one consumer advocate noted to Pew that in theory a $200 loan to a customer with average income could have fees of $400 or more under the original 5 percent payment option. It is worth noting that the risk of such a loan occurring under the 5 percent payment option would be minimal. Depository institutions would likely be prevented from making such a loan by their prudential regulators, or would avoid doing so because of reputational concerns or competitive considerations (loans could be profitable to depositories at far lower cost). And we note that non-depository state-licensed lenders will conduct most of their business under the longer-term ability-to-repay section of the rule. They are engaging in and are likely to continue engaging in far more aggressive practices than the 5 percent payment option would allow, such as charging more than $1,100 in fees on a $500 loan repayable over more than a year. (See Section 4(b) of this letter for discussion.)

[154] With "default" and "default rate" defined as discussed in Section 6(a)(iv) of this letter. For reasons discussed there, alternative methods of defining default, such as what the Bureau proposed for the "portfolio default rate" conditional exemption, would not work for purposes of this recommendation.

[155] In particular, we expect depository institutions to have no problem with such a threshold. Some non-depository lenders that are able to achieve greater levels of efficiency than are typical today may also be able to lend sustainably under this provision, but we anticipate that non-depository lenders would primarily make loans under the longer-term ability-to-repay part of the rule because it generally allow loans with larger payments, longer durations, higher prices, and generally greater profitability.

Therefore, while we do not believe that a cost limitation is absolutely necessary to the success of the 5 percent payment option, we believe that the 50 percent cost limit suggested here would respond to concerns that some stakeholders have raised about high costs relative to loan size, while also enabling the Bureau to allow loans that last somewhat longer than six months in response to some lender concerns. Numerous large and mid-sized banks have reported to Pew that limiting loan costs to half of principal would not impede their ability to offer small-dollar credit.[156] Based on Pew's analysis and our outreach to financial providers and other stakeholders, we are confident that adding the proposed cost threshold would simultaneously provide strong consumer protection and preserve the viability of the 5 percent payment option for lenders, and accordingly we believe the Bureau has ample basis to including this threshold in this optional conditional exemption.

- To implement this recommendation, the CFPB could reasonably make this conditional exemption available only to loans that cost half of principal or less, or alternatively, create a two-tiered section within the 5 percent payment-to-income ratio alternative.[157] As explained below, Pew is proposing certain other adjustments that should only apply to loans that cost less than half of principal.

<u>Third, make additional adjustments to simplify compliance</u>. If loans have costs of more than half of principal, all of the provisions from the 2015 SBREFA outline should apply, with none of the following modifications. If loans have costs of half of principal or less, the following modifications are strongly encouraged to enable providers to offer these loans successfully:

- (1) Ensure there is no limit on the number of times consumers may borrow as long as origination fees are constrained by limiting how often they may be charged or making them pro rata refundable in the event of early repayment.[158] Limits on the number of times consumers may borrow

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[156] However, financial providers were quick to point out that sustainably providing small-dollar payday loan alternatives to borrowers with damaged credit histories requires charging fees that will typically exceed those of mainstream credit products. As explained throughout this letter, Pew's analysis shows that depositories could offer small loans profitably under the 5 percent payment option with fees that are at least six times lower than payday lenders and that the vast majority of borrowers and public view as fair.

[157] A two-tiered approach would have the benefit of allowing the Bureau to implement the 5 percent payment-to-income ratio alternative in a way that is no more burdensome on lenders than what the Bureau contemplated in the SBREFA proceedings or in the proposed rule at 48 F.R. 48039 et. seq. Tier 1 would be the 5 percent payment option as originally proposed, and Tier 2 would limit costs to half of principal if lenders take advantage of new modifications proposed in the following paragraphs of this letter.

[158] It is our understanding that the originally-proposed two-loan limit would not be necessary if risks associated with reborrowing were curtailed, and that ensuring affordable payments via the 5 percent payment-to-income threshold and

discourage providers from developing programs, encourage overborrowing, discourage early repayment, and drive consumers to higher-cost loans after they reach the maximum number.

- (2) Do not require any external data pulls or reporting to a real-time database as long as providers report to credit bureaus on a monthly basis.

- (3) Permit lines of credit as long as they otherwise comply with the provisions of this section, because closed-end loans with viable terms are not always permitted under state law, and lines of credit may enable lower-cost lending than closed-end loans.

- (4) Clarify that deposits may be used as proof of income, and allow installment payments set at 6 percent of deposits, a figure that is reasonably equivalent to 5 percent of gross income.

- (5) Allow terms longer than six months, because limiting costs to half of principal makes a term limit unnecessary.[159]

- (6) Do not prohibit deposit account sweeping or taking deposit account balances negative, provided that no lender-originated penalty fees apply for incurring a negative balance on loan payments (e.g. overdraft or NSF fees charged by the maker of such loan). Any potential risk to consumers associated with account sweeping would be more than offset by ensuring that lender-originated penalty fees would not apply (combined with the limit on size of monthly payments equal to 5 percent of the borrower's monthly income).

- (7) Do not apply "disclosure payment attempt" requirements to loans made under the 5 percent payment-to-income ratio alternative.

If these changes are made, lower-cost loans would likely become widely available, replacing much of today's high-cost credit market and saving consumers billions of dollars annually. The modifications recommended above would alleviate substantive concerns while preserving the fundamental value of the 5 percent payment option. Based on our extensive outreach to banks, credit unions, other lenders, and our own thorough modeling,

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eliminating the chance of recurring origination fees curtail those risks. Further, any risk of default masking (refinancing loans to avoid default or charge off) could be curtailed through regulatory examination.

[159] It is critical that the Bureau *either* limit loan terms to six months under this conditional exemption *or* limit costs to 50 percent of loan principal. Otherwise loan duration and cost could reach harmful or inappropriate levels relative to the size of the loan.

we are confident that lenders could profitably offer loans under the 5 percent payment-to-income ratio alternative with terms that are far superior to conventional payday loans and which the vast majority of the public (and borrowers themselves) view as fair. This would provide tremendous benefit to consumers and the market generally.

Including a conditional exemption based on the 5 percent payment-to-income ratio alternative is in the best interests of consumers. As Pew has discussed in Section 4 of this letter and elsewhere, high-cost installment loans will be common under the core ability-to-repay test proposed by the Bureau, and the 5 percent payment-to-income ratio alternative is critical to enabling lower-cost small loans at sufficient scale to provide substantial benefit to consumers generally. If these loans are permitted and enabled by the 5 percent payment option, they would likely be so competitive that consumers would choose them in sufficient volume to replace a large share of the payday loan market, and a significant share of the market for auto title loans, small subprime installment loans, rent-to-own loans, pawn loans, and heavy use of overdraft services as credit while perhaps also reducing intentional use of late fees and other expensive penalty fees used as credit. These loans would be far more beneficial to consumers than those issued under the ability-to-repay section, with smaller payments, reasonable terms, lower prices, and reporting to credit bureaus.[160]

For these and other reasons, Pew estimates that implementing the 5 percent payment-to-income ratio alternative in the final rule would save consumers billions of dollars per year.

Further, adding the 5 percent payment option as a conditional exemption in the final rule would reflect the strong desires of borrowers and the public generally. (See Sections 3(d) and 3(e) of this letter.)

Including the 5 percent payment-to-income ratio alternative is legally justified. The Bureau has taken the position that it has the authority to create conditional exemptions to the core ability-to-repay rule, and Pew agrees. By imposing an ability-to-repay mandate on all makers of covered loans, the Bureau acted within its authority to redress the clear and widespread harms in this market. By providing a number of conditional exemptions for both short- and longer-term loans but making these conditional exemptions optional, the Bureau has added to the allowable means of complying with the rule but has not overstepped its authority by inappropriately mandating specific rules or compliance requirements.

[160] Lenders would of course be expected to maintain reasonable underwriting procedures for these loans, but would be free to innovate as experience and technology allow for new ways to underwrite and originate small loans as long as they abide by the simple product safety standards associated with the 5 percent payment-to-income ratio alternative.

Further, by offering conditional exemptions that are based on prescriptive limits on lending practices (such as the maximum number of allowable loans or required amortization techniques) or loan terms (such as maximum loan size or finance charges as in Section 1041.11 of the proposed rule) the Bureau has presumably tailored its conditional exemptions in a manner designed to limit potential harm to consumers. And by making these limits objective (no more than 3 loans in a row, no greater than 28 percent plus a $20 fee, and so on) the Bureau has established an easier compliance process for lenders relative to the core ability-to-repay rule in an effort to help ensure that certain types of credit may flow to consumers who want or need it.

If the Bureau has the legal authority to include any of these conditional exemptions, then it also has the legal authority to offer a conditional exemption based on the 5 percent payment-to-income ratio alternative as proposed here. The 5 percent payment option is backed by at least as much data and research as any of the other proposed conditional exemptions, including extensive empirical data showing that 5 percent of a borrower's paycheck is a reasonable benchmark or proxy for presuming a borrower's ability to repay (see Section 3(f)(i) and Appendix C of this letter).

Still, there is no *guarantee* under any part of the rule that no consumers will be harmed in association with covered loans, and the same would be true of the 5 percent payment option. There is ample existing research for the Bureau to conclude that loans meeting the 5 percent payment-to-income ratio alternative would be reasonably safe for most borrowers and that any potential risk of harm could be managed through ongoing regulatory supervision procedures. Overall, there is strong justification for implementing the 5 percent payment option and determining that it would benefit consumers and the market generally.

Similarly, there is no *guarantee* that lenders would choose to use any of the proposed conditional exemptions. If there were no rational basis for believing that lenders would use the conditional exemptions with sufficient regularity to help credit continue to flow under the rule and benefit consumers, that could arguably undermine the overall legal justification of the rule.[161] Yet there is ample basis for believing that the 5 percent payment option would help beneficial credit flow under the rule; in fact, the 5 percent payment option is by far the most likely of all the conditional exemptions proposed to date to do so.[162] We are pleased that the Bureau requested input about the viability of the 5 percent payment option as a means to protect consumers while enabling access to credit, and we

[161] See, e.g., http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

[162] We discussed this throughout Section 4 and the rest of this letter as well as in prior publications. See also, e.g., http://www.pewtrusts.org/en/research-and-analysis/analysis/2016/09/07/the-cfpbs-proposed-payday-loan-regulations-would-leave-consumers-vulnerable.

trust that the Bureau has received sufficient affirmative input (from Pew and others) to establish a reasonable basis for including it in the rule and indeed a strong case for doing so.[163]

Further, Pew has concluded that adding the 5 percent payment option could improve the CFPB's overall justification for its rulemaking in various ways. For one, it would add substantially to the consumer benefit equation. Pew estimates that the 5 percent payment option would eventually save consumers in excess of $10 billion per year because millions would gain access to loans from their banks or credit unions at prices that are more than six times lower than what they will otherwise pay on loans made under the longer-term ability-to-repay section of the rule and far cheaper than alternative credit sources noted above such as rent-to-own. While the Bureau may reasonably estimate a different number, it is clear that under the 5 percent payment option the savings to consumers would likely be substantial. Further, the compliance burden would be far lower for lenders, making the overall legal balancing test for this rulemaking more favorable to the Bureau.

Finally, while the Bureau's present rulemaking exercise is notable for being the first-ever attempt at regulating payday and auto title lending at the federal level, the Bureau is not only regulating payday and auto title lenders. The rule applies to all lenders of covered loans, including depository institutions like banks and credit unions, and the Bureau has a responsibility to tailor the rulemaking so that it creates a level playing field to promote fairness and competition among all market stakeholders.[164] Based on Pew's analysis and that of many stakeholders in the bank and credit union community, the CFPB's rule would effectively prevent depositories from entering this market unless the 5 percent payment option is incorporated as a conditional exemption in the final rule.[165]

[163] In addition to more than 30 credit unions and banks that supported the 5 percent payment option during the SBREFA process (see 81 F.R. 48039), many stakeholders have concluded that the 5 percent payment option is desirable. See, e.g., Appendices I, G, and H. We understand that the Bureau is receiving additional supportive comments about the 5 percent payment option from other banks, credit unions, trade associations, consumer groups, thought leaders, and other stakeholders during the comment period. In fact, Pew has joined a separate comment letter calling on the CFPB to implement the 5 percent payment option, submitted by a group of diverse stakeholders including non-governmental organizations and representatives of banks that operate one in six bank branches in the United States.

[164] The 5 percent payment option would not be exclusively available to banks and credit unions, but we do expect that non-depository institutions would be unlikely to use it because they will prefer the greater flexibility and profitability associated with making loans under the core ability-to-repay test. See also footnote 155 (the 5 percent payment option would be viable to some non-depository lenders that are able to achieve a much greater level of operational efficiency than what is typical today).

[165] As Pew has discussed in Section 4 of this letter and elsewhere, *banks and credit unions are highly unlikely to be able to offer small-dollar loans under the core ability-to-repay test in a manner that is at once safe and affordable for consumers, competitive at scale against non-bank lenders that are not bound by prudential regulation and other systemic limitations that apply to depository institutions, and profitable to the bank or credit union.*