The Consumer Financial Protection Bureau’s Proposed Rule to End Payday Debt Traps

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I. Introduction

A borrower takes out a payday loan when a borrower is struggling financially or facing a cash squeeze. However, for many borrowers, payday loans make their already bad financial situation even worse or cause them financial ruin. Borrowers are set up to fail with payday loan payments that borrowers are unable to repay. Because of the unaffordable payments, borrowers must choose between borrowing another loan, defaulting on the loan, or bypassing on paying for rent or basic living expenses such as food and medical care.¹

Due to the risky practices in the payday loan market that have worsened borrowers’ financial struggles, the Consumer Financial Protection Bureau (“CFPB”) proposed a rule to end payday debt traps. The CFPB’s proposed rule would require lenders to take steps to ensure consumers have the ability to repay their loans and stop payday lenders’ repeated attempts to gain fees from consumers.²

II. Consumer Harm from Payday Loans

A payday loan is a short-term loan that typically is for $500 or less and is due on the borrower’s next payday. When the borrower takes out a payday loan, the borrower

gives lenders access to his or her checking account or writes a post-dated check for the full balance that the lender can deposit when the loan is due. The cost of the loan, which is the loan finance charge, may range from $10 to $30 for every $100 borrowed. A typical two-week payday loan with a $15 fee per $100 borrowed equates to an annual percentage rate of nearly 400%.³

Approximately 12 million Americans use payday loans yearly. Most borrowers earn less than $30,000 annually.⁴

Millions of borrowers are trapped by predatory payday loans. A consumer takes out a payday loan when struggling financially or facing a cash squeeze. Many of the people most vulnerable to predatory payday loans are low-income families, households of color, and seniors on fixed incomes – people who already occupy a fragile spot in the American economy. Payday lenders know that most borrowers will not be able to repay easily, which is why payday lenders aggressively market their loans to those without access to affordable credit.⁵

One example of a consumer taking out a payday loan when struggling financially or facing a cash squeeze is a low-wage worker’s car breaking down. She has to get to

work and take her kids to school. However, she has bad credit, no credit cards, and no way to pay for the car repair.⁶

A second example is Christina Sarno, who borrowed $200 from a payday lender to avoid homelessness after having her first child. A third example is Latita Parnell, who tried to avoid being homeless by borrowing $700 from a payday lender. To get out of the payday loan debt, Latita had to file bankruptcy.⁷

What is reprehensible and shameful is that payday lenders prey on consumers such as them who are already financially vulnerable by placing interest rates that are nearly 400% and tacking astronomical fees on loans to trap borrowers to take out more loans, owe more, and be in a never-ending cycle of debt.⁸

When borrowers take out payday loans, borrowers face steep penalty fees and bank account closures from having a negative balance for an extended period of time due to a failed debit attempt from a lender. More than four out of five short-term loans are re-borrowed in a month and the majority of short-terms loans are borrowed by consumers who take out at least ten loans in a row.⁹

After defaulting on a payday loan, some consumers become subject to aggressive and harmful debt collection efforts. Attempts by online payday lenders to debit payments

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from a consumer’s checking account add a steep, hidden cost to online payday loans. Payday lenders capitalize by trapping consumers in debt consumers cannot afford.10

III. Protections Provided by the CFPB’s Proposed Rule

The first protection the CFPB’s proposed rule would include is the full-payment test, which would require lenders to determine whether the borrower can afford the full amount of each payment when the payment is due and still meet basic living expenses and major financial obligations.

Additionally, the CFPB’s proposed rule would further protect against debt traps by making it more difficult for lenders to push distressed borrowers into re-borrowing or refinancing the same debt. The proposal would cap the number of short-term loans that can be made in quick succession.11

The second protection the CFPB’s proposed rule would include is a principal payoff option for certain short-term loans. Under the proposal, consumers could borrow a short-term loan up to $500 without the full-payment test as part of the principal payoff option that is directly structured to keep consumers from being trapped in debt. The proposal would prevent lenders from offering this option to consumers who have outstanding short-term or balloon-payment loans or have been in debt on short-term loans more than 90 days in a rolling 12-month period. Another part of the payoff option is that

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a lender could offer a borrower up to two extensions of the loan, but only if the borrower pays off at least one-third of the principal with each extension.\textsuperscript{12}

The third protection the CFPB’s proposed rule would include is less risky longer term lending options. The proposal would also permit lenders to offer two longer-term loan options with more flexible underwriting, but only if they pose less risk by adhering to certain restrictions. The first option would be offering loans that generally meet the parameters of the National Credit Union Administration’s “payday alternative loans” program where interest rates are capped at 28\% and the application fee is no more than $20. Another option would be offering loans that are payable in roughly equal payments with terms not to exceed two years and with an all-in cost of 36\% or less, not including a reasonable origination fee, so long as the lender’s projected default rate on these loans is 5\% or less. Lenders would be limited as to how many of either type of loan lenders could make per consumer per year.\textsuperscript{13}

The fourth protection the CFPB’s proposed rule would include is debit attempt cutoff. Under the proposal, lenders must provide written notice to consumers before attempting to debit the consumer’s bank account to collect payment for a loan. After two straight unsuccessful attempts, the lender would be prevented from debiting the account again unless the borrower provides the lender with new and specific authorization. The CFPB proposed this protection because repeated unsuccessful withdrawal attempts by


\textsuperscript{13} Id.
lenders to collect payment from consumers’ accounts pile on insufficient fund fees from the bank or credit union, and can result in returned payment fees from the lender.\textsuperscript{14}

\textbf{IV. Consumer Advocates’ Criticisms of the CFPB’s Proposed Rule}

Although consumer advocates praise the CFPB’s proposed rule for taking a significant step towards the end of payday lenders’ predatory practices, consumer advocates argue that the rule would leave lenders free to charge any rate and set almost any term as long as lenders make a “reasonable determination” that the borrower can repay the loan. Under this vague directive, payday lenders are in the control seat, because the rule would allow lenders direct access to borrowers’ checking accounts.\textsuperscript{15}

The National Consumer Law Center argues that the CFPB’s rule needs to be tightened up to close loopholes. Lenders could make up to three back-to-back payday loans and could restart the sequence after only 31 days. Longer-term loans could also have balloon payments that trigger re-borrowing. Under the CPFB’s proposed rule, payday lenders would still have access to the borrower’s bank account, there would be no underwriting for ability to pay, payments would be tied to the borrower’s payday, and a high, unaffordable cost could leave families struggling to pay other expenses and exposed to overdraft fees.\textsuperscript{16}

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Consumer advocates also argue that the CFPB is too slow to action. As each day passes without new rules, more consumers fall victim to loans that may ensnare them in a cycle of debt.  

V. Conclusion

The CFPB’s proposed rule takes a significant step towards the end of payday lenders’ predatory practices. However, if the CFPB does not improve the draft rule, payday loan borrowers will not gain access to affordable credit and will still be left with 400% interest payday installment loans. The CFPB should ensure that the final rule includes effective, pro-consumer product safety standards such as limiting loan payments to 5% of a borrower’s paycheck. With a few strong fixes, the CFPB could create a policy that protects millions of hardworking consumers.
