A brief from THE PEW CHARITABLE TRUSTS | July 2015

Understanding the CFPB Proposal for Payday and Other Small Loans

Overview

Research shows that in the payday and vehicle title loan markets, lenders' and borrowers' interests are not aligned because profitability for lenders depends on loans being unaffordable for customers.[1] Lenders offer short-term loans with balloon payments that typically consume one-third or more of a customer's next paycheck.[2] These payments make it hard for borrowers to retire debts while covering other expenses, so they typically borrow again quickly, paying fees over time that are far in excess of the loan's advertised price. This repeat borrowing, which lenders rely on for their profitability, keeps borrowers in expensive debt for an extended time. And when customers struggle to pay, "preferred repayment positions"—control of borrowers' vehicle titles or access to their deposit accounts—give lenders the power to collect before other bills are paid.

To address this misalignment and the resulting harm to borrowers while still preserving the availability of credit, the Consumer Financial Protection Bureau (CFPB) has issued a proposed framework for regulating payday, auto title, and similar small-dollar loans.[3] Under these rules, lenders could either assess a borrower's income and expenses before issuing credit or abide by a set of alternative requirements governing the terms of the loan. (See Table 1.)

Though it does not cover all small-dollar loans, the CFPB proposal—which provides a basis for future federal rule-making—addresses many of the most dangerous products on the market and attempts to strike a balance between protecting consumers and facilitating access to credit. High-interest, small-dollar loans would remain available under the proposal, but revenue would be constrained and lenders would probably need to consolidate stores and become more efficient, as has happened in states that have enacted significant consumer protections.

Overall, the proposal would transform the market in positive ways. It rightly emphasizes ensuring affordable payments and safe loan structures, requiring that most products become installment loans with smaller, manageable payments. That is what the vast majority of borrowers want, according to The Pew Charitable Trusts' survey research.[4] In particular, the longer-term "alternative" loan sections of the proposal include critical consumer safeguards—affordable loan payments, lower costs, and reasonable durations. (See Sections 4 and 5.)

However, the proposal is very complex, which could hinder compliance, transparency, and enforcement. Certain sections of the proposal allow for harmful loan features, including unaffordable payments, excessive or unnecessarily high prices, and—as the market shifts toward installment loans—unreasonable loan durations that drive up costs.[5] The section with the greatest risks for consumers covers longer-term "ability-to-repay" loans (see Section 3), which would require lenders to evaluate borrowers' financial condition but which lacks other important consumer protections. (See Table 2 for a summary of the risks associated with each section.)

This brief provides an analysis of each section of the proposal and offers recommendations to strengthen it, based upon Pew's extensive research on this market. If incorporated, these recommendations would make it more difficult to issue dangerous loans and easier to offer safer ones, and would better align the interests of lenders and borrowers.

Table 1

The CFPB Proposal for Payday, Vehicle Title, and Other Small Loans

A framework for future rule-making

	Short-term loans Loan duration of 45 days or less	**Longer-term loans** Loan duration of more than 45 days; all-in annual percentage rate (APR) of more than 36%; preferred repayment position*	
Ability to repay (ATR)	**1 Short-term ATR** Lender must assess borrower's finances to ensure ability to repay: • Verify income • Verify major financial obligations • Check borrowing history[†] • Make a reasonable determination that sufficient income remains to cover loan costs and estimated living expenses	**3 Longer-term ATR** Lender must assess borrower's finances to ensure ability to repay: • Analysis is similar to short-term ATR loan • If borrower shows signs of distress, refinancing restrictions apply • Does not limit loan size, payment size, cost, duration, or how long a lender may hold access to a deposit account or car title	
Alternative requirements	**2 Short-term alternative** • $500 maximum loan amount • Mandatory 60 days without borrowing after three consecutive loans • 90-day maximum indebtedness per 12-month period • Taper to zero loan balance after several consecutive loans • No holding of car titles	**4 Longer-term alternative: NCUA-type loans[‡]** • 28% interest + $20 fee • Loan amounts of $200 to $1,000 • Six-month maximum loan duration • Maximum of two loans per six-month period	**5 Longer-term alternative: 5% payment-to-income ratio[§]** • Monthly payment cannot exceed 5% of gross monthly income • Six-month maximum loan duration • Maximum of two loans per 12-month period

Notes: Sections 2 and 3 are the areas of greater risk to consumers based on Pew's analysis.

Collecting payment: Lenders would be required to give notice before attempting to collect payment from a borrower's deposit account and could make no more than one additional attempt at withdrawal if the first attempt fails.

Multiple loans: Lenders may not issue a loan to a borrower who already has a covered loan outstanding.

Not covered: Most pawn loans, credit card accounts, real estate secured transactions, student loans, deposit account overdraft, and loans greater than 45 days where the lender has no preferred repayment position.

* **All-in APR:** A measure that would include interest, application and other fees, and the cost of ancillary products sold along with the credit. **Preferred repayment position:** Includes holding a car title or having access to a borrower's deposit account to help secure repayment.

† **Check borrowing history:** For all loans, lenders would have to check commercially available reporting systems that operate according to CFPB specifications, and report loan activity to them. Lenders might also be required to check borrowers' default history.

‡ **NCUA-type loans:** Loans that generally satisfy the requirements of the Payday Alternative Loan program under the National Credit Union Administration.

§ **Payment-to-income (PTI) ratio:** For example, 5 percent PTI for an average borrower who earns $30,000 annually, or $2,500 monthly, would equal a monthly payment of no more than $125 ($2,500 x 5%), including principal and fees.

Source: Consumer Financial Protection Bureau, "Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered," March 26, 2015; Pew analysis.

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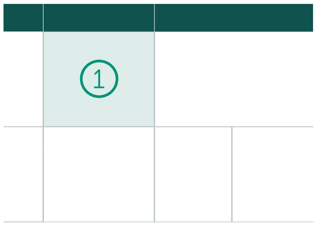
Section 1.
Short-term ability-to-repay loans



Lender must assess borrower's finances to ensure ability to repay:

- Verify income
- Verify major financial obligations
- Check borrowing history
- Make a reasonable determination that sufficient income remains to cover loan costs and estimated living expenses

Summary

Covers loans lasting 45 days or less. Lenders would be required to assess applicants' ability to repay by verifying income, major financial obligations, and borrowing history. Based on this analysis, lenders would make a "reasonable determination" that applicants have the capacity to repay the loan while meeting major financial obligations and covering estimated living expenses.

Strengths

The guidelines governing these loans would require lenders to assess and verify a borrower's income, housing costs, and credit and legal obligations, resulting in periodic payments that are smaller than most payday and auto title loans require today. These guidelines emphasize the importance of preserving sufficient room in borrowers' budgets for food, utilities, clothing, medical care, transportation, and other recurring living expenses as well as irregular ones. The proposal acknowledges the difficulty in determining some expenses, such as those that are shared or paid in cash.

Weaknesses

No significant weaknesses, yet little if any credit would be offered under this section because few consumers who use small-dollar loans can afford to repay them in full within 45 days without borrowing again to make ends meet.[6]

Short-Term Ability-to-Repay Loans: Availability and Risks

Availability of credit	Low	Lenders would be unlikely to make these loans because few borrowers can repay them in such a short time.
Risk of unaffordable payments	Low	Very few applicants will qualify
Risk of unreasonable durations*	Low	45-day maximum
Risk of excessive costs†	Low	Affordability requirement and short term limit costs
Overall risk to consumers	Low	Very low availability means few consumers exposed to potential harm

* Unreasonable loan durations could stretch loan repayment over many months or several years and drive up costs. Here, that risk is low due to the ability-to-repay requirement and 45-day maximum duration.

† Markets for deep subprime loans often feature prices that are higher than necessary to ensure widespread access to credit for borrowers and profitability for lenders. This is because financially struggling borrowers tend to focus more on obtaining fast approval for a loan than on obtaining a loan at the lowest cost. (See The Pew Charitable Trusts, "How State Rate Limits Affect Payday Loan Prices," 2014.)

Recommendations:

Lenders are unlikely to make many loans under this section of the proposal because few borrowers have the ability to repay a loan in this short a time. See "Longer-term ability-to-repay loans" on Page 7 for recommendations on improving the rules governing ability to repay.

2 Section 2. Short-term alternative loans

- $500 maximum loan amount
- Mandatory 60 days without borrowing after three consecutive loans
- 90-day maximum indebtedness per 12-month period
- Taper to zero loan balance after several consecutive loans
- No holding of car titles

Summary

Covers loans lasting 45 days or less. In exchange for exemption from ability-to-repay underwriting requirements, lenders would cap loans at $500 and limit borrowers to three consecutive loans and no more than 90 days of indebtedness per 12-month period (enforced through a database reporting system). Lenders would be required to “taper” off indebtedness—that is, create a pathway out of debt.

Strengths

This section of the proposal includes important provisions to curtail the harm caused by loans due in full in a lump sum, which pose a great risk to customers because their unaffordable payments can lead to repeated borrowing. The section also prohibits auto title lending.

Weaknesses

This section would codify in a federal rule a product that very closely resembles a conventional payday loan, which consumes 36 percent of the average borrower’s next paycheck. Typical customers, however, can afford to repay only 5 percent of their income, which means that many would be forced to take out another loan to make ends meet. Loans of this type would require vigorous enforcement to prevent lender evasion of loan limits and ensure that borrowers do not continue to experience the harm pervasive in today’s balloon-payment payday loan market.

Short-Term Alternative Loans: Availability and Risks

Availability of credit	**Somewhat high**	Lenders would be likely to continue offering lump-sum loans in addition to longer-term products.
Risk of unaffordable payments	**High**	Preserves unaffordable single-payment payday loans
Risk of unreasonable durations	**Low**	45-day maximum loan length; no more than 90 days of indebtedness per year
Risk of excessive costs	**Somewhat high**	Loans likely to feature needlessly high APRs similar to current average of 400%, but limits on indebtedness will reduce overall spending
Overall risk to consumers	**Somewhat high**	Unaffordable payments and extremely high prices would be likely, with safeguards mitigating some harm

Short-Term Alternative Loans Would Not Eliminate Very High Costs

Loan principal	Number of two-week loans	Finance charges
$500	3	$300
$500	6	$600

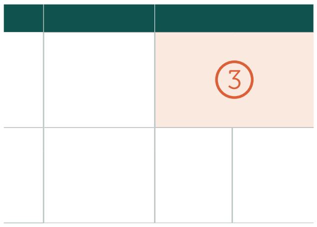
Note: Costs are based on a fee of 20 percent per pay period (521% APR). Loan prices are frequently higher in states without price limits and from lenders operating online without state licenses, and are frequently lower in states with price limits.

Recommendations:

Eliminating this section of the framework and prohibiting these short-term alternative loans would better protect consumers by establishing a clear regulatory expectation that lenders design safer loans that fit within borrowers' budgets. Such a move would also require less regulatory oversight to protect against excessive use of harmful loans. Access to short-term credit would remain widely available under the longer-term loan sections of the proposal (Sections 3, 4, and 5, discussed below) because borrowers would have the option to pay back their loans early without penalty. However, if this short-term alternative loan section remains part of the proposal:

- Lenders should be prohibited from making short-term alternative loans to people who have used any other form of credit from the same lender or its affiliates in the past 60 days, as well as for 60 days after the loan sequence.
- Borrowers should be allowed to obtain longer-term loans from other lenders at any time so they can move to credit with more affordable payments; the 60-day cooling-off period should not apply to longer-term loans obtained from other lenders.
- The maximum allowable annual indebtedness should be reduced from 90 days to 45 days to be consistent with the dividing line between short- and longer-term loans in the rest of the proposal.
- The mandate that lenders taper loans—that is, create a pathway out of debt—should require the initial balance to amortize to zero over three successively smaller loans (e.g., if the first loan is for $300, the second would be for no more than $200, and the third for no more than $100).

Section 3.
Longer-term ability-to-repay loans



Lender must assess borrower's finances to ensure ability to repay:

- Analysis is similar to short-term ATR loan
- If borrower shows signs of distress, refinancing restrictions apply
- Does not limit loan size, payment size, cost, duration, or how long a lender may hold access to a deposit account or car title

Summary

Covers longer-term loans, lasting more than 45 days with APRs, including all fees, of more than 36 percent, for which lenders have a preferred repayment position. Guidelines would be similar to those for short-term ATR loans: Lenders would be required to assess applicants' ability to repay by verifying income, major financial obligations, and borrowing history. Based on this analysis, lenders would make a "reasonable determination" that applicants have the capacity to repay the loan while meeting major financial obligations and covering estimated living expenses. A more rigorous assessment would be required for refinancing if a borrower is unable to afford the payments or the loan requires a balloon payment.

Strengths

The guidelines governing these loans would require lenders to assess and verify a borrower's income, housing costs, and credit and legal obligations, resulting in periodic payments that are smaller than most loans require today. The guidelines emphasize the importance of preserving sufficient room in borrowers' budgets for food, utilities, clothing, medical care, transportation, and other recurring living expenses as well as irregular ones. Unlike conventional lump-sum payday loans, this type of loan would tend to have affordable installment payments. The proposal states that an especially high rate of default or refinancing in a lender's portfolio would indicate that the methods used to determine borrowers' ability to repay may not be reasonable.

Weaknesses

Because these loans contain no limits on length, they could extend for unreasonably long periods, such as more than a year to repay a $500 loan, with customers ultimately repaying more than triple the original principal. Such loans exist on the market today and would likely persist.[7] As proposed, the CFPB rule could be used as a justification for expanding the use of a preferred repayment position for longer-term and larger loans because it includes no limits on how long lenders may hold access to checking accounts or vehicle titles, which gives lenders the power to collect from financially vulnerable consumers over extremely long periods of time. The proposal also places no restrictions on the use of large upfront fees, creating a risk of "loan flipping": When lenders can charge high fees at the beginning of a loan term, they have strong incentive to steer borrowers into refinancing arrangements that trigger new origination fees. This leads to APRs and overall costs to borrowers that are higher than those advertised for the original loan.

Longer-Term Ability-to-Repay Loans: Availability and Risks

Availability of credit	**Somewhat high**	This type of credit would be widely available because most borrowers would be able to afford small installment payments.
Risk of unaffordable payments	**Somewhat low**	Monthly payments fit most borrowers' budgets
Risk of unreasonable durations	**High**	Strong lender incentive for unnecessarily long loan terms, with potential for abuse of preferred repayment positions over extended periods
Risk of excessive costs	**High**	Unreasonable loan lengths drive up costs to levels far higher than necessary to ensure availability of credit and profitability
Overall risk to consumers	**High**	Highest-risk loan type in the proposed framework with widely available loans that are not subject to effective controls on duration, cost, payments, or size

Longer-Term Ability-to-Repay Loans Would Not Eliminate Very High Costs

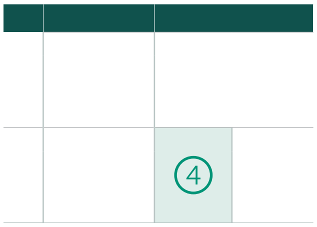
Issuer	Principal borrowed	Loan duration	Monthly payment	Finance charges
Speedy Cash	$500	18 months	$90.35	$1,126.30
Advance America	$500	6 months	$306.97	$1,341.84
Castle Payday	$500	11 months	$291.25	$2,703.75
CashCall	$2,525	47 months	$294.46	$11,314.62

Note: The referenced Speedy Cash loan is available in Arizona as an auto title installment loan. The referenced Advance America loan is available in Texas as an extended loan.

Recommendations:

- Place reasonable limits on loan duration or, alternatively, on how long a lender may hold a preferred repayment position. A scalable threshold would probably work best, such as one month per day of income borrowed.[8] (For example, a $300 loan made to a borrower making $100 per day would have a maximum duration of three months.) Limits of six months for $500 loans and 12 months for larger loans could also serve this purpose. This would help preserve protections found in state law (most states restrict the duration of loans with preferred repayment positions) as the market adjusts to the CFPB's rules by providing longer-term loans with smaller periodic payments.
- Discourage loan flipping by requiring partial (pro rata) refunds of all fees for loans that are repaid early or refinanced or allowing only one origination fee—a one-time charge for new or refinanced loans—per year.

Section 4. Longer-term alternative: National Credit Union Administration-type loans



- 28% interest + $20 fee
- Loan amounts of $200 to $1000
- Six-month maximum loan duration
- Maximum of two loans per six-month period

Summary

Covers longer-term loans lasting more than 45 days with APRs, including all fees, of more than 36 percent, for which lenders have a preferred repayment position. In exchange for exemption from underwriting requirements assessing customers' ability to repay the loans, lenders would follow rules designed to ensure that loans fit within most borrowers' budgets. The rules would be similar to the National Credit Union Administration's Payday Alternative Loan program for loans lasting up to six months. (See 12 CFR 701.21.) This loan type could also require lenders to check a real-time reporting database and limit borrowers to two loans per six-month period.

Strengths

The requirements are fairly easy for lenders to fulfill and borrowers to complete, which would facilitate the continued availability of small loans currently offered by approximately 1 in 7 federal credit unions.[9] The section also mandates repayment in amortizing installments and limits durations to six months. The costs of these loans are low, and codifying them into the final regulation may encourage more depository institutions to offer them.

Weaknesses

The revenue available to lenders from this loan type is unlikely to support the expansion of this product beyond a small share of credit unions and some nonprofits or workplace lenders. The limit of two loans per six-month period may encourage customers to borrow more than they need and to choose not to prepay even when they can afford it, because their access to future credit would be restricted. (See sidebar on Page 10.) Requiring lenders offering these loans to go beyond their normal underwriting processes and check a specialty reporting system as well as send loan information to all available systems in real time may discourage depository institutions and other lenders from offering small loans that have relatively low costs and affordable payments.

NCUA-Type Loans: Availability and Risks

Availability of credit	**Somewhat low**	Because of the limited revenue available, few institutions will be able to earn a profit offering these types of loans.
Risk of unaffordable payments	**Somewhat low**	Monthly payments, generally fit borrowers' budgets
Risk of unreasonable durations	**Somewhat low**	Six-month maximum
Risk of excessive costs	**Low**	National Credit Union Administration guidelines limit charges
Overall risk to consumers	**Somewhat low**	Structural constraints—including tight restrictions on duration and cost—minimize consumer risk, but availability will also be limited

Costs for NCUA-Type Loans Will Be Low

Principal borrowed	Loan duration	Monthly payments	Maximum finance charges
$300	3 months	$111.37	$34.11
$500	6 months	$93.60	$61.60
$1,000	6 months	$183.87	$103.22

Recommendations:

- Remove the limit of two loans per six months in order to encourage customers to borrow only what they need and to prepay when possible. (See sidebar on this page.)
- Allow reporting to either the commercially available reporting system described in the CFPB proposal or to major credit bureaus on a normal schedule in order to make it easier and more cost-effective for depository institutions to issue these more consumer-friendly loans.
- If lenders offer longer-term alternative loans, but no covered short-term loans, do not require them to check reporting systems beyond the steps they already take as part of an origination process.

Why the Proposal Should Not Cap the Number of Longer-Term Alternative Loans

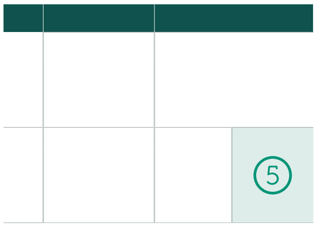
In the longer-term alternative loan sections (Sections 4 and 5), the proposal sets firm guidelines for affordable payments, loan duration, and cost that would make these loans the safest of the covered loans. However, capping the number of these loans that a borrower can use could increase, rather than decrease, overall harm to consumers. Under the proposal's two-loan limit, customers who carry loans for the maximum six-month term could remain in debt the entire year, while those who repay early would be barred from borrowing again should the need arise. Customers who want to avoid jeopardizing their access to credit in this way may borrow larger amounts for their two loans than necessary and might not repay early even when they are able to do so.

In interviews with Pew, credit union executives who oversee loan programs with similar constraints on borrowers reported these precise adverse effects. But in focus groups, customers said they preferred to borrow only as much as they needed at any one time and to repay early if they were able—both of which reduce the cost of credit overall. When banks issued deposit advance loans (single-payment, payday-style loans), the median draw was only $180, an amount that most customers can afford to repay in less than two months.[*] In Colorado, where loans are repayable in affordable installments without prepayment penalty and customers' future borrowing is not restricted, three-quarters of loans are repaid at least a month early.[†]

* Consumer Financial Protection Bureau, *Payday Loans and Deposit Advance Products: A White Paper of Initial Data Findings* (2013), 27, http://files.consumerfinance.gov/f/201304_cfpb_payday-dap-whitepaper.pdf.

† Colorado Office of the Attorney General, "2013 Deferred Deposit/PaydayLenders Annual Report" (2014), 2, http://www.coloradoattorneygeneral.gov/sites/default/files/uploads/2013%20DDL%20Composite%20FINAL_4.pdf.

5 Section 5. Longer-term alternative: 5% payment-to-income loans



- Monthly payment cannot exceed 5% of gross monthly income
- Six-month maximum loan duration
- Maximum of two loans per 12-month period

Summary

Covers longer-term loans lasting more than 45 days with APRs, including all fees, of more than 36 percent, for which lenders have a preferred repayment position. In exchange for exemption from underwriting requirements assessing customers' ability to repay, lenders would follow rules designed to ensure that loans fit within most borrowers' budgets. Lenders would structure loans with monthly installment payments of no more than 5 percent of each borrower's monthly income, with durations of no more than six months, and no fees for prepayment of the loan. This loan type requires lenders to check and report to a real-time reporting database and limits borrowers to two loans per 12 months.

Strengths

This loan type enables lenders to issue small credit without incurring substantial underwriting costs, has strong consumer-friendly requirements on duration and payment size, and provides an avenue for banks to offer small-dollar loans with affordable payments at much lower prices than payday lenders. Research demonstrates that the required payment size is sufficient to allow lenders to operate profitably but small enough that most borrowers can afford it. For example, a borrower making $2,500 monthly would pay no more than $125 per month for no more than six months. The six-month limit ensures that loans do not carry unreasonable durations. The clarity of this section of the CFPB proposal also sets a clear, strong foundation for future legislation in states that seek to reform payday lending.

Weaknesses

The two-loan limit jeopardizes borrowers' access to future longer-term alternative loans, encouraging them to borrow more than they need in the near term and to not prepay even if they can afford to do so. (See sidebar on Page 10.) Requiring banks or other lenders that already report to credit bureaus to check and provide information to an additional commercially available reporting system might discourage them from offering small loans that would be beneficial to consumers because of their lower costs and affordable payments. This loan type does not restrict the use of large upfront fees, creating risk of loan flipping—steering borrowers to refinance—which results in APRs and overall costs that are higher than those advertised for the original loan. Furthermore, this loan type does not allow for a line of credit option, which could give consumers added flexibility and potentially bring down loan prices by minimizing lenders' origination costs.

5% Payment-To-Income Loans: Availability and Risks

Availability of credit	**Somewhat high**	Lenders can offer these loans and still operate profitably by becoming more efficient; some already issue similar loans. Streamlined underwriting requirements and clear guidelines may encourage banks to begin offering small loans at much lower cost than payday lenders.
Risk of unaffordable payments	**Somewhat low**	Monthly payments, strictly limited to a generally affordable 5% of income
Risk of unreasonable durations	**Somewhat low**	Six-month maximum
Risk of excessive costs	**Somewhat low**	Likely to result in lower costs; front-loaded fees may increase risk of loan flipping
Overall risk to consumers	**Somewhat low**	Strict restrictions on payment size and loan duration significantly curtail potential harm to consumers; wide availability of credit that has more affordable payments and lower prices than most currently available loans and the proposal's other loan types (See Figure 1)

Longer-Term Alternative Loans Limit Payment Size and Duration to Contain Costs

Income	Maximum monthly payment @ 5% PTI	Loan duration (total payments)	Principal borrowed	Maximum finance charges
$30,000 per year ($2,500 per month)	$125	6 months ($750)	$500	$250

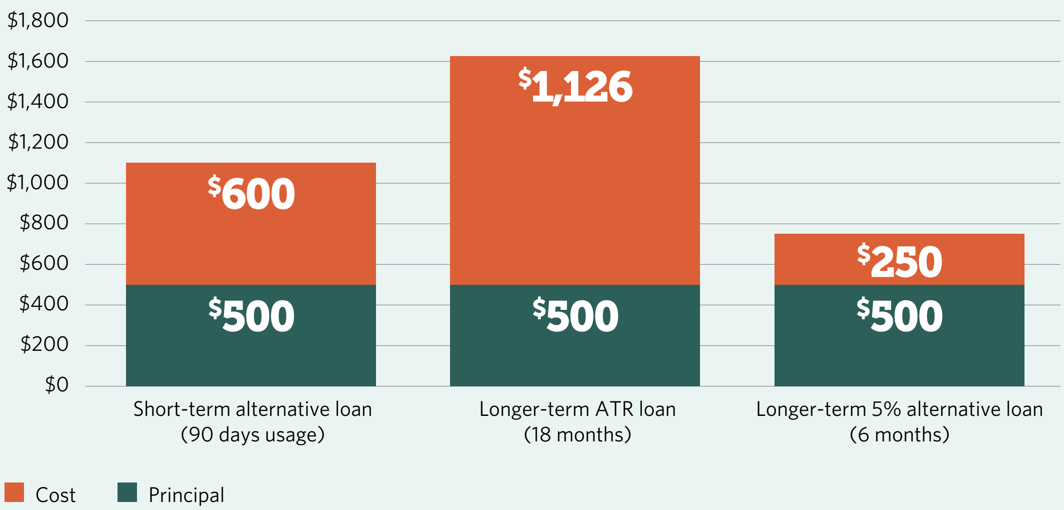
Recommendations:

- Remove the limit of two loans per 12 months in order to encourage customers to borrow only what they need and to prepay when possible. Removing the limit will encourage less indebtedness by giving customers the flexibility to borrow again in the future should they wish to do so. (See sidebar on Page 10.)
- Discourage loan flipping by requiring partial (pro rata) refunds of all fees for loans that are repaid early or refinanced or allowing only one origination fee—a one-time charge for new or refinanced loans—per year.
- Allow reporting to either the commercially available reporting system described in the CFPB proposal or major credit bureaus on a normal schedule in order to make it easier and more cost-effective for depository institutions to issue these more consumer-friendly loans.
- If lenders offer longer-term alternative loans, but no covered short-term loans, do not require them to check reporting systems beyond the steps they already take as part of an origination process.
- Reduce lenders' origination costs and provide borrowers with more flexibility by allowing fully amortizing six-month lines of credit in accordance with the other guidelines included under this section.

Figure 1

5% Alternative Loans Include Safeguards That Will Lower Costs and Protect Consumers

Costs likely to be highest under longer-term ATR section



Note: The longer-term 5 percent alternative loan includes limits on payment size and duration that will help lower costs. For example, a typical borrower with an income of $30,000 could be required to make payments no larger than $125 per month, which would effectively limit total loan costs to $250 for a six-month $500 loan. By comparison, higher-cost loans are likely to be issued under other sections of the proposal. The short-term alternative loan costs in the example above are based on a fee of 20 percent per pay period. Loan prices are frequently higher in states without price limits and from lenders operating online without state licenses, and lower in states with price limits. The longer-term ATR loan used in this example is the auto title installment loan referenced on page 8.

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Summary analysis of loan types under CFPB proposal

The greatest risk to borrowers lies in Section 3 (longer-term ATR). Among the loans likely to be available, the least risk is found in Sections 4 and 5 (longer-term alternatives).

Short-term loans: The short-term alternative loan option (Section 2) creates risk for consumers because it would allow lenders to continue issuing lump-sum loans due in full on the borrower's next payday. Research shows that these loans are unaffordable for most borrowers, consuming an average of 36 percent of their gross paychecks.[10] The other loan types allowed within the proposal would provide generally affordable payments and adequate availability of credit if this lump-sum alternative were eliminated.

Longer-term loans: The primary risk to borrowers lies in the option based on their ability to repay the loan (Section 3). As devised, these underwritten loans include no restrictions on the amount, duration, or cost of loans; payment sizes; or how long lenders may retain access to borrowers' deposit accounts or car titles. Payday and title installment lenders have used unreasonable durations to drive up borrowers' costs, and under the proposal, that practice would probably continue: Many borrowers are likely to have at least a small share of income available for loan payments, so lenders will still be able to issue high-cost loans with very long terms.

The longer-term alternative loans in Sections 4 and 5 control the risk of high costs and unreasonable lengths by limiting durations and other loan terms.

Table 2

CFPB's Proposed Loan Types and Their Associated Risks and Availability

	Short-term loans		Longer-term loans		
	1 Short-term ATR	2 Short-term alternative	3 Longer-term ATR	4 Longer-term alternative: NCUA-type loans	5 Longer-term alternative: 5% payment-to-income ratio
Risk of unaffordable payments	Low	High	Somewhat low	Somewhat low	Somewhat low
Risk of unreasonable durations	Low	Low	High	Somewhat low	Somewhat low
Risk of excessive costs	Low	Somewhat high	High	Low	Somewhat low
Overall analysis	**Low availability**	**Somewhat high availability**	**Somewhat high availability**	**Somewhat low availability**	**Somewhat high availability**
	Low risk	**Somewhat high risk**	**High risk**	**Somewhat low risk**	**Somewhat low risk**

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Recommendations

Make dangerous loans safer

- **Limit loan duration or limit how long lenders may hold a preferred repayment position.** Protect against unreasonable loan durations; constrain lenders' unique and potentially harmful power to collect payment before other bills are paid by accessing borrowers' bank accounts or repossessing their vehicles.
- **Eliminate the short-term alternative loan, or, if it is kept, significantly increase requirements for offering it.** Protect against deceptive or unaffordable loan structures.
- **Require all fees to be pro rata refundable for loans that are refinanced or repaid early.** Mitigate the risk of loan flipping and the resulting harm.

Make safe loans easier to provide

- **Remove the two-loan limit on the longer-term alternative loans.** Encourage customers to borrow only what they need and to prepay when possible.
- **Make data reporting and verification for longer-term alternative loans easier.** Encourage responsible lenders to offer safer, lower-cost products.

A Foundation to Build On

Going forward, it is important to note that the CFPB's proposal is not an endorsement of high-cost lending, nor does it pre-empt state laws governing small-dollar loans. Instead, the proposal lays a foundation upon which states may build stronger consumer protections. Fifteen states do not have payday loan stores, and 26 do not have auto title lending.[11] Pew does not recommend an expansion of high-interest credit in those states. Because the CFPB lacks authority to regulate interest rates, it will be important for states to continue to do so.

Conclusion

The CFPB proposal for small-dollar loans seeks to fix the fundamental problem with payday and auto title loan markets: unaffordable lump-sum payments that lead to extended reborrowing. It would generally require reasonable installment payments and has the potential to steer the market toward loans that better align lenders' and borrowers' interests. If finalized in rule-making, it would create the first-ever federal guidelines for this market. With the recommended modifications and simplifications, the CFPB proposal is likely to lead to significantly better results for American consumers.

Endnotes

1 The Pew Charitable Trusts, *Payday Lending in America: How Borrowers Choose and Repay Payday Loans* (2013), 13–18, http://www.pewtrusts.org/~/media/assets/2013/02/20/pew_choosing_borrowing_payday_feb2013-%281%29.pdf.

2 The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences* (2015), 11, http://www.pewtrusts.org/~/media/Assets/2015/03/AutoTitleLoansReport.pdf; The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions* (2013), 53, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2013/PewPaydayPolicySolutionsOct2013pdf.pdf.

3 Consumer Financial Protection Bureau, "Small Business Advisory Review Panel for Potential Rulemakings for Payday, Vehicle Title, and Similar Loans: Outline of Proposals Under Consideration and Alternatives Considered," March 26, 2015, http://files.consumerfinance.gov/f/201503_cfpb_outline-of-the-proposals-from-small-business-review-panel.pdf.

4 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 22–24.

5 Markets for deep subprime loans often feature prices that are higher than necessary to ensure widespread access to credit. This is because financially struggling borrowers tend to focus more on obtaining fast approval for a loan than on obtaining the lowest cost. 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. For discussion of the risks associated with unaffordable payments, excessive loan durations, and other practices in this market, see The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 26–47.

6 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 26–32.

7 Speedy Cash, "Arizona Online Installment Title Loans Rates and Terms," https://www.speedycash.com/rates-and-terms/arizona/; Advance America, Texas, "Extended Loan," https://www.advanceamerica.net/home; Castle Payday, "Castle Payday Rates," https://www.castlepayday.com/loan-rates; CashCall, "Current Rates," https://www.cashcall.com/rates.

8 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 42, 65; The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences*, 20–21.

9 National Credit Union Administration, *Trends and Estimates of Consumer Savings from Payday Alternative Loan Programs*, April 29, 2015.

10 The Pew Charitable Trusts, *Payday Lending in America: Policy Solutions*, 30–31, 53.

11 The Pew Charitable Trusts, *Payday Lending in America: Who Borrows, Where They Borrow, and Why* (2012), 21, http://www.pewtrusts.org/~/media/legacy/uploadedfiles/pcs_assets/2012/PewPaydayLendingReportpdf.pdf; The Pew Charitable Trusts, *Auto Title Loans: Market Practices and Borrowers' Experiences*, 4.

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